The treatment of distressed banks

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This article suggests some reforms of regulatory architecture for the treatment of distressed banks. Our main recommendations are:

- *a special bankruptcy regime for banks should be implemented ;*
- *strong, truly independent supervisory agencies should be established ;*
- *the incentives of the top managers of distressed banks should not be kept unchecked ;*
- *procyclicality of solvency regulations should be dampened by the introduction of "automatic stabilisers" ;*
- *one should move toward centralised supervision in economic areas which are meant to be integrated.*

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The current financial crisis is extremely severe. It is also multidimensional, and it has already led to many analyses and policy-oriented documents.[1] This contribution focuses on the treatment of distressed banks, a key element of the regulatory architecture which has however attracted insufficient attention so far. The treatment of distressed banks can however not be treated independently of other dimensions of this architecture, which some of our recommendations will therefore indirectly address.

As far as the treatment of distressed banks is concerned, we can think of public action as pursuing two potential objectives:

• The harmonisation of the treatment of distressed banks across countries in order to ensure a level-playing field while promoting global financial stability; it is useful in this respect to distinguish individual bank distress and systemic distress.

• The promotion of cooperation between countries in the treatment of cross-border distressed banks.

This paper discusses these issues in turn. A key idea that underlies the analysis is that the current regulatory system is fragile because it has not dealt in an explicit fashion with the harmonisation of the treatment of distressed banks. This stands in contrast with the efforts in terms of harmonisation of capital ratios under Basel I and II. Of course, this harmonisation has several significant flaws which have to be addressed too. But the idea that we need harmonised capital ratios is a sound one, and it should be extended to the treatment of distressed banks. This is very important because of 'political economy' considerations: whether in good or bad times, supervisors always face pressure from lobbies and from politicians that undermine the proper functioning and stability of the financial system. There is therefore a cost in leaving things vaguely specified or unspecified and therefore at the discretion of supervisors. They need to be protected *ex ante* through a system of transparent rules. Of course, there is always a potential cost of such rules in terms of loss of flexibility. However, the current system has clearly erred in the other direction. The paper offers a number of recommendations to try and move closer to a rule-based system that maintains enough flexibility.

1| Reforming prudential policy for distressed banks

Even if the Basel process has clearly contributed to the harmonisation both of risk management practices by banks and regulatory requirements across countries,[2] and was still undergoing important reforms (Basel II) when the crisis hit, it was insufficient to contain the crisis. We suggest that Basel II should be reformed in depth, and that the objectives of regulatory/supervisory systems should be significantly reassessed.

1|1 Implementing a special bankruptcy regime for banks

Several episodes of the crisis have revealed that banking authorities of many G20 countries did not have sufficient legal powers to treat banking distress in a timely and efficient way. Moreover the discretion given to domestic supervisors by Basel II's Pillar 2 revealed counterproductive in the management of the crisis, since it exposed them to political pressure and threats of judicial recourse by the shareholders of distressed banks. Generally speaking, it is not really useful to harmonise regulatory requirements for banks if enforcement of these requirements is left to the discretion of domestic supervisors, who act under political and legal constraints that differ a lot across countries.

Therefore, a first priority for restoring a level playing field for international banking and avoiding a race to the bottom in terms of enforcement of prudential policy is reforming and harmonising bankruptcy laws for banks. Banks are not ordinary firms: partly thanks to deposit insurance, even under extreme solvency problems, their shareholders and managers still have considerable scope for "gambling for resurrection".[3] In the absence of timely supervisory action, shareholders and managers still have an interest in

1 *See for example Brunnermeier* et al. *(2009), Tirole (2008) or the G30 (2009) for excellent wide-ranging analyses.*
2 *The Basel accords were initially designed for internationally active banks but they have been adopted, after some modifications, by the domestic regulators of many countries.*
3 *This has been well-documented for example in the case of the US Savings and Loan crisis of the 1980's; see for example Dewatripont and Tirole (1994) for an overview of this episode.*

continuing the bank's activity, typically increasing the ultimate damage to the deposit insurance fund and to the financial system as a whole.

A good place to start harmonising bank insolvency procedures would be the US system put in place in 1991 under FDICIA (Federal Deposit Insurance Corporation Improvement Act), which is centered around the important notion of PCA, or 'prompt corrective action' (note that Brazil put in place a system with similar features and worth looking at). This system has the advantage of starting to address a crisis gradually, classifying banks in five categories depending on (various measures of) capital ratios: well capitalised (capital ratio > 10%); adequately capitalised (> 8%); undercapitalised (< 8%); significantly capitalised (< 6%); and critically undercapitalised (< 2%). The first two categories face no restrictions, but the bottom three categories face more and more severe restrictions on actions (eg dividend payments, asset growth, acquisitions, and, in the extreme, receivership). The key idea is to allow the supervisor to intervene *before* things become too bad.

There is broad agreement that PCA has had a beneficial effect (see for example Benston and Kaufman, 1997, and Aggarwal and Jacques, 2001), and there are also theoretical analyses in its favor (see for example Freixas and Parigi, 2008).

Our first recommendation is therefore that:

• A harmonised special bankruptcy regime should be established for banks involving PCA, i.e. giving to the supervisory agency powers to limit the freedom of bank managers (and possibly remove them) and shareholders (and possibly expropriate them) *before* the bank is technically insolvent.

1|2 Putting in place strong and independent supervisory agencies

A necessary complement to the reform of bankruptcy law for banks is the protection of supervisors from pressure by politicians and lobbies.

This is only possible with a strong, independent, well-staffed and well-paid supervisor. And it is likely to be easier with consolidated supervision of all government-insured deposit taking institutions within each country. What is clearly undesirable is for example the US situation, i.e. the ability for financial institutions to choose between two *ex ante* supervisors – the OCC (Office of the Comptroller of the Currency) for banks and the OTS (Office of Thrift Supervision) for savings and loan – an ability which has led to under-regulation by the OTS, mainly due to the fact that its budget depended on the number and size of institutions under its supervision.

Consolidated supervision can however in some cases have drawbacks, even if it may allow for administrative cost savings. Since early detection of bank distress is not always possible, supervisors might be tempted to hide a bank's problems in the hope that they might disappear and therefore not reveal their failure to identify these problems early enough.[4] This creates a potential conflict of interest between *ex ante* supervision and *ex post* intervention. In this respect, the US system is attractive, with its distinction between the institution in charge of *ex ante* supervision (the OCC for banks and the OTS for savings and loans) and the institution in charge of dealing ex post with distressed banks, i.e. the Federal Deposit Insurance Corporation (FDIC). Moreover, endowing supervisors with a clear, focused mission can enhance their accountability. Indeed, as shown by evidence on the behavior of public agencies,[5] the simpler their task, the easier it is to evaluate how well they have performed, i.e. to keep them accountable.

However, note that there are various means of addressing the issue of political pressure and accountability, namely by using simple, publicly observable (and thus hard to manipulate) mandatory criteria for triggering regulatory intervention. Once again, this is an advantage of the PCA doctrine of the US FDICIA.

Our recommendations for the organisation of supervision are that:

• Supervisors should have the independence, resources and expertise to fulfill their mission properly. If public authorities are unwilling to raise supervisory budgets, this pleads, *ceteris paribus*, for

4 *See Dewatripont and Tirole (1994) for a discussion.*
5 *See Wilson (1989); see also Dewatripont* et al. *(1999) for an incentive-theoretic perspective.*

a simplification of the regulatory regime. Basel II did go in the wrong direction here, with big banks being allowed to compute risks themselves through complex internal models, a task where they had a clear conflict of interest and which proved too difficult for proper oversight by supervisors.

• In terms of the structure of regulation, one should not allow banks to 'play one regulator against the other' as has been the case in the United States with OCC and OTS. Beyond this, while consolidated supervision –bundling *ex ante* monitoring and *ex post* intervention – allows for cost savings and simpler coordination, it may reduce accountability. Guarding against this can be achieved through reduced discretion in terms of intervention by the supervisors (as in the US FDICIA).

1|3 A set of simple regulatory requirements, rather than a single, complex capital ratio

The Basel Committee on Banking Supervision (BCBS) has put too much emphasis on its Capital Adequacy Requirement. The Northern Rock episodes, and several others, have shown that a solvent bank can rapidly become distressed for lack of liquidity and that transformation risk cannot be neglected. In the case of Northern Rock for example, Blundell-Wignall *et al.* (2008) point out that in June 2007 (roughly three months before the depositors run started) its regulatory capital requirement (computed on the basis of Basel II risk weights and approved by the Financial Services Authority – FSA) was slightly above GBP 1.5 billion, while British authorities ultimately had to inject around GBP 23 billion, i.e. more than 15 times the regulatory requirement, just to maintain the bank afloat.

It is not the role of supervisors to decide on the level of capital, and more generally of the risk management strategies of all commercial banks. These are business decisions that should normally be left to the assessment of banks' managers and administrators. It is only when supervisors anticipate that a bank is likely to face distress in a near future (and therefore exert negative externalities on its depositors or on the financial system as a whole) that supervisors can and must intrude. As the crisis has shown, indicators for such future distress cannot be summarised by a single capital ratio, even if very complex. Instead, we believe that regulatory intervention should be triggered by a whole set of relatively simple (and publicly verifiable) indicators, including measures of liquidity risk, as well as exposures to macroeconomic shocks, and bilateral exposures to other banks or systemic institutions.

The emphasis on the probability of failure of individual banks (epitomised by the use of the value-at-risk criterion) by the BCBS was obviously misplaced. Indeed, a 1% probability of failure does not have the same consequences if it means that 1% of the banks fail every year or alternatively that the whole banking system fails every hundred years. Therefore it is crucial for regulators to find ways to discourage "herding behaviour" by banks, or at least to penalise an excessive exposure to the business cycle. This means that new indicators of risks have to be designed, based on correlation with aggregate activity, rather than absolute probability of failure.

Similarly, the main reason for public intervention by Central Banks and Treasuries in the current crisis was the protection of the financial system as a whole, and in particular "core infrastructures" such as large value payment and clearing and settlement systems. Anticipating (rationally) that public authorities are bound to intervene if these infrastructures are in danger, banks have taken insufficient risk prevention activities in relation with these "core infrastructures". To contain moral hazard, it is therefore necessary to regulators to find ways to penalise or at least limit the externalities that large and complex banking organisations exert on these "core infrastructures".

Finally the notion that fine tuned capital requirements could be sufficient to limit the incentives of bank managers to take excessive risk has revealed grossly incorrect. Other instruments, such as some form of control of bank managers' remunerations as well as the implementation of appropriate internal governance measures and adequate risk management systems are certainly much more adapted to curb risk taking incentives by bankers. We find more reasonable to interpret regulatory capital requirements as defining, together with other indicators, thresholds for supervisory intervention rather than recommendations for risk management policies of banks.

Our recommendations in this section are that:

• One should think of the signals triggering intervention as admittedly crude indicators of the risk of potential problems. Therefore, simplicity if crucial, because it reduces manipulability and enhances transparency and credibility.

• A single capital requirement, even when it is very complex, is not enough to limit risk taking by banks. Therefore, a battery of indicators has to be designed by regulators, in order to provide simple signal of the various dimensions of banking risks (including liquidity and transformation risks, risks of large losses, exposure to macroeconomic shocks, ...) and used simultaneously to determine whether supervisory corrective action is needed.

• Other dimensions of regulatory control are to be explored to explicitly curb the incentives of bank managers for excessive risk taking: top managers' remunerations, shareholder representation, and internal risk management systems. This cannot remain as vaguely defined as in Pillar 2 of Basel II.

2| Macroeconomic and systemic considerations

Recent years have witnessed staggering growth of some individual banks, both nationally and internationally. The size of individual banks has grown tremendously, both in large countries like the United States and in small countries (Iceland being only the most extreme case), whose banks have become very large indeed relative to GDP. This development has several consequences for the supervision of banks. Big institutions always have bargaining power in 'normal times', through their lobbying of Governments and supervisors. The aftermath of the Lehman Brothers bankruptcy has moreover clearly indicated that one cannot afford to let big institutions fail, even if the cost of a bailout is significant and therefore politically unattractive.

Beyond this, it is important for public authorities to face the evidence: banking crises do happen in market economies. Therefore, it is important to have in place explicit crisis-management mechanisms when they come. Three issues have to be discussed in this respect:

(i) Who decides when we are 'in a crisis'?
(ii) What should be done *ex post*? And
(iii) How to reduce the probability and social cost of a crisis?

As far as the first question is concerned, it is important to involve the three main actors in the decision process, the Central Bank, the supervisor and the Treasury. Indeed, each has access to relevant information, and the Treasury brings with it democratic legitimacy. Their task would be, by declaring a crisis, to allow for the potential release of public funds, something which should not be possible in normal times. When thinking of the exact decision process by which a crisis can be declared, one has to keep in mind two objectives:

(i) it is important on the one hand to avoid excessive use of public funds through excessively frequent crisis declaration; and

(ii) it is also important that, when a 'real crisis' hits, it is promptly declared, so as to release needed public funds.

Clearly, achieving both objectives can only happen if a crisis-management system has been devised *ex ante*, and if regular consultations take place between the Central Bank, the supervisor and the Treasury at highest level.[6]

Concerning the second issue, that is, *ex post* crisis management, a first thing to always keep in mind is that undercapitalised banks do not function well as credit providers to the economy. While there is a natural tendency for public authorities to delay action – which is fiscally costly – in the hope that things will get better, it is typically a very bad idea. The contrast between Scandinavia and Japan in the 1990s is good evidence of that.

Ex post recapitalisation of individual banks by public authorities in times of crisis can take several forms: partial (or full) nationalisation, insurance provision

6 *Something which does not seem to happen now (see for example Davies, 2008, page 365, for the case of the United Kingdom).*

for bank loans, or the purchase of 'toxic' assets to be parked in a 'bad bank'.[7] There is no consensus among academics about the best way to proceed here. Some principles seem natural however:

(i) at least as far as banks which are performing worse than the average of the sector are concerned, there is clearly no reason to protect shareholders or managers in the process; the goal should be to protect depositors and taxpayers;

(ii) speed matters; the goal is to get healthy banks working as soon as possible.

Finally, what about reducing ex ante the probability and social cost of a systemic crisis? This is connected to the debate on reducing the procyclicality of regulation. This topic has quite rightly been the subject of various analyses. See for example Brunnermeier *et al.* (2009), who describe very well the bad externalities banks in trouble exert on other banks when trying to raise their capital ratios, for example by selling assets. It is indeed important for prudential regulation to take into account economy-wide indicators and not simply individual bank solvency.

In terms of the subject of this paper, let us here just stress once again the need to avoid the danger of bank undercapitalisation in bad times. Reducing procyclicality could then mean aiming at 'adequate' capital ratios in bad times and higher ratios in good times, so as to limit the vicious circle discussed by Brunnermeier *et al.* (2009). One avenue, which they discuss among others, is Spanish-style dynamic provisioning. Alternatively, in order to limit the overall amount of capital banks need to have (and its associated cost), one could follow Kashyap *et al.* (2008) and their suggestion of capital insurance. Under this system, banks would pay an insurance premium to institutions against a promise of capital infusion in times of crisis.

The scheme put forward by Kashyap *et al.* is ingenious. They are confident that private institutions or investors would be willing to provide such capital insurance. This may be too optimistic. However, it could also be provided by Governments. This is in fact what happens anyway when Governments end up recapitalising banks in times of crisis. The difference with what has happened so far is that the Government could, *ex ante*, charge periodic insurance premia against such 'catastrophe insurance'. Similarly, it is conceivable to require *ex ante* that banks having access to Emergency Liquidity Assistance (ELA) by the Central Banks pay a periodic fee for this service.

Our recommendations in this section are that:

• Public authorities should expect crises to happen. They should put in place a mechanism that allows a crisis to be formally declared (an event which will allow the release of public funds). This means formalising *ex ante* cooperation between the relevant actors (Central Bank, supervisor, Treasury) with this contingency in mind.

• *Ex post* crisis management should keep in mind that undercapitalised banks do not function well. One should go for 'real' recapitalisation, even if it is costly. There are several options – temporary nationalisation, insuring bank loans or parking toxic assets in bad banks – that are possible. The objective should be to get lending going again without delay by properly capitalised banks, without excessively burdening taxpayers.

• Under current regulation, maintaining adequate capitalisation in bad times has procyclical effects. Avoiding this calls for introducing 'automatic stabilizers' into the regulatory system, such as higher capital ratios in good times, dynamic provisioning, capital insurance (privately or publicly provided), or procyclical deposit insurance premia.

3| INTERNATIONAL COOPERATION

Globalisation has underlined both the current limits of, and need for improvements in, international cooperation in the treatment of distressed banks. There is indeed a tension between the tendency to favour the growth of international banks (through global or regional pro-trade and pro-capital mobility policies) and the reliance on national (whether 'home' or 'host' country) supervisors.

7 *Interestingly, this issue generated significant research at the time of the 'transition' from central planning to a market economy by former communist countries in the 1990s. See for example Mitchell (2001) and Aghion* et al. *(1999), who argue that a mixture of recapitalisation and the liquidation of non-performing loans can under some conditions be the optimal solutions for a Government trying to serve the interests of taxpayers while being at an informational disadvantage with respect to bank management concerning the quality of the loan portfolio.*

3|1 The case of the European Union

In the European Union, the tension between the prevalence of national regulators and the emergence of cross-border banks, which has been encouraged by the Single Market initiative, is very significant. This is particularly problematic because one has witnessed two competing policy rationales over recent years: the first one saying that the potential of the Single Market, and its associated productivity gains, could only be realised through synergies resulting from cross-border mergers; and the second one worrying that it is important for Member States to retain national ownership of their big banks, for 'strategic control' reasons or mere national pride motives.

In this respect, what happened recently to the banking and insurance group Fortis is very instructive. The 2007 takeover battle over ABN-Amro, which was ultimately 'won' by the trio RBS, Santander and Fortis, was hostile and controversial (and, *ex post*, an operation that turned out to be much too expensive for the acquirers); but it was very much in line with the Single Market programme, since it accelerated cross-border banking ties. However, by breaking up a 'Dutch jewel', it was definitely not popular in the Netherlands. And the question of who should be the lead supervisor of the Belgian-Dutch Fortis was a subject of debate between the two countries. This did not facilitate cooperation between public authorities when the crisis came in September 2008, crisis which, it is fair to say, the Dutch authorities did take advantage of in order to reassert control over 'their' share of the bank.

The lesson of this episode is that one can expect competition to be at times 'controversial', especially when things go sour *ex post*, due to business mistakes or market reversals. In such circumstances, one can expect nationalistic reactions, especially since national authorities see quite differently the acquisition of national firms by foreign ones than the acquisition of foreign firms by national ones.

Just like with protectionism in general, such adverse asymmetric reactions have to be kept under control through a credible set of legal provisions. These should take as starting point the fact that national supervisors can be expected to be pressured to pursue national objectives, just like public supervisors can be expected to face lobbying by national industry.

However, the current practices are not reassuring in this respect. Indeed, relying on national supervisors (which is currently the case, with consolidated oversight by the home country supervisor supplemented by domestic oversight by the host country supervisor), requires coordination and cooperation that is going to be tested in times of crisis, as the Fortis example demonstrates. Note that the Fortis crisis happened just after the introduction of the European 'Memorandum of Understanding' (MoU), which was meant to promote cooperation in financial stability and crisis management! While this MoU is full of good intentions (on information exchanges, involvement of all interested parties, the pursuit of the interests of the banking group as a whole, 'equity', …), its problem is that it is 'a flexible tool that is, however, not enforceable' as stressed by Praet and Nguyen (2008, page 371; this is a view also shared by the Centre for European Policy Studies (CEPS) *Task Force Report*, 2008).

While it is certainly possible to beef up such MoU's and make them more binding, one has to face the facts: if one really wants to promote the Single Market in banking (which makes sense if one wants to pursue the Single Market in non-financial sectors), and therefore the emergence of European and not just national banks, one should simultaneously favour the emergence of a European supervisor and of a European deposit insurer. We understand this is not an obvious goal (see the CEPS *Task Force Report* (2008) for example on some obstacles on the way to centralisation, an objective it subscribes to), but we think it is necessary.

Note that this statement is related to the Single Market, that is, applies to the entire European Union and not just the Euro area. We understand that this complicates things, since there would be an asymmetry between Central Banking, which would involve several players, and EU-wide supervisor and deposit insurer. The case for Euro-area supervisor and deposit insurer seems therefore stronger. However, it is important to stress the crucial need for much stronger coordinated mechanisms of enforcement than exist now whenever two territories face significant cross-border banking relationships.

Our recommendation in this section is that:

• In economic areas which are meant to be very integrated, like the European Union, one should move towards a centralised supervisor and a centralised deposit insurer.

3|2 International coordination in general

The European Union is in a sense an 'extreme' case of economic integration. Note however that many emerging economies face very significant foreign bank presences. There too the need for coordination in times of crisis – and in particular 'who takes care of depositors' – is crucial, especially since these emerging countries have more limited means of effectively guaranteeing deposits. A crisis in one such country where depositors would fail to be protected could have devastating effects, by triggering bank runs on other, 'similar' countries!

The problem is less severe for intercontinental relations involving large rich or emerging economies, because:

(i) they have more ammunition to tackle crises; and

(ii) they have more limited cross-banking relations. However, these have been growing over time, especially with the opening up of banking markets and the spread of risks through securitisation. And unfortunately, the regulatory and supervisory safeguards have not been raised to match these evolutions: harmonisation still has not taken place concerning the treatment of banks in distress.

Clearly, this can lead to a host of problems, especially since we have to keep in mind that crisis management has to take place with under great time pressure. Let is simply stress the two most important ones:

• First, there is the issue of when public intervention can take place and what are the public intervention powers. We have stressed earlier that the US system establishes by FDICIA, with PCA, was a good idea; but this system is definitely not generalised, making such prompt action unavailable in other countries.

• Second, and most importantly, is the question of depositor protection. Note that banks, when setting up operations in a foreign country, can go for subsidiaries – which then have legal personality in that country and become national firms – or simply branches, which remain an integral part of the bank.

There are clear potential incentive problems facing the home supervisor in terms of consolidated supervision, with the risk of being pressured to 'limit damages' and leaving part of the mess to foreign countries. This can be really dangerous in terms of contagion.

While it is beyond this short paper to analyse in detail the way forward in terms of cooperation in crisis management, we can highlight a couple of general principles:

• While a global supervisor and deposit insurer may be beyond reach, it has to be considered seriously if one really wants to integrate further the banking market. What applies to the EU Single Market applies, *mutatis mutandis*, to a Single World Market. Concretely, one could give real powers to a supranational authority like the Basel Committee on Banking Supervision.

• If one thinks that centralisation is either impossible or undesirable, one should at least get serious about joint crisis management. The two goals of avoiding contagion and avoiding regulatory arbitrage by banks should be kept in mind. We have already stressed the need to harmonise intervention thresholds, following and idea like PCA. Moreover, if one keeps the idea of domestic deposit insurance, whatever the legal form of cross-border banking relationships, it is crucial to think of a more even-handed approach between home-country and host-country supervision. Indeed, the decision of whether to 'save' the bank, and therefore fully protect all its depositors, and at which conditions, should in fact be taken jointly by the various authorities. More generally, in the absence of a supranational supervisor, what is required is an *ex ante* credible agreement, or MoU, between the various countries about how to share supervisory and deposit-insurance responsibilities. Such a MoU should be as explicit as possible in order to have a chance of functioning in times of crisis. Once again, there should be standardisation of such MoU's to spread best practices.

Our recommendations in this section are that:

• If one wants to keep integrating the world banking market, one should seriously consider partial centralisation of supervision and deposit insurance at the world level.

• Barring such centralisation, it is important to foster best practices in establishing credible Memoranda of Understanding for cross-border banking crisis management between authorities that detail in particular the respective rights and obligations with respect to intervention thresholds and deposit insurance.

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