FEDERAL RESERVE BANK of ATLANTA

Agency Problems and Goal Conflicts:

Is the European Structure of Banking Regulation and Supervision Likely to Be Vulnerable to a Banking Crisis?

Presented at a conference on

THE GOVERNANCE OF CENTRAL BANKS

Sponsored by the Sveriges Riksbank

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August 31, 2006

Introduction

- Paper posits that because agencies charged with financial regulation may have many different objectives and the process is complex, it can often leads to conflicts.
- Conflicts are of two types
  - Conflicting goals
  - Agency problems associated with policies to implement regulations and/or policies
    - National level and international/cross-border level
- Regulatory and legal design affects both the origins of the conflicts and how these conflicts are resolved

Plan for Presentation

- Paper first puts forward a framework for thinking about these conflicts and political economy of how they are resolved in practice
- Then evaluates the strategy of the EU in designing its financial supervisory and regulatory structure
- Bottom line is that the EU has embarked upon a risky strategy- especially with respect to deposit insurance structure and financial stability that may not be robust to handling or avoiding a financial crisis should the proper circumstances present themselves.
    - Eva Srejber, deputy governor of the Riksbank reached similar conclusions in a speech earlier this year
- Some policy recommendations

Examples of How Goal Conflicts Can Arise

- Because of the different mix of goals, policies may be applied or implemented differently and jurisdictional conflicts can arise
  - Monetary policy v banking supervision
    - Inflation period in late 1980s and need to raise interest rates was a critical catalyst for thrift crisis and bank failures in US
    - Expand credit at bottom of recession and take more risk which supervisors may not want to encourage when risk premia are higher
- Banking supervision and consumer protection
- Safety and soundness v competition
- Investor protection v depositor protection
- Efficiency v protectionism
  - State champions v market competition
    - UK- with Abby National acquisition, French bail out of Credit Lyonnas, and recent activities to block mergers in Italy
- In EU – LLR function (financial stability) and deposit insurance schemes –especially with topping up options

Jurisdictional Conflicts Can Also Arise

- Banks v bank holding companies-both in Europe and US
  - In US -State v federal regulators, FRB v OCC
    - OCC and preemption of state laws on predatory lending, mortgage lender/broker licensing laws, escrow account laws, and credit score disclosure laws
- In EU – LLR function – who is responsible for what and who decides?
- In EU Countries – different mix of responsibilities assigned to CB v other regulatory bodies
- In EU- Home country supervises banks chartered in that country, but foreign banks and branches may also be operating there
  - Branches may be bigger and more important than home country chartered intuitions. But host country is responsible for financial stability but may lack info to make appropriate decisions

Two Ways to Structure Conflict Resolution

- External Resolution
  - When conflicts arise among agencies or across country boundaries then it usually falls to political process through legislative or some pan-national body to resolve the conflict in political arena.
  - External resolution carries with it big risks in times of financial crises

- Internal Conflict Resolution
  - When an agency has two different and conflicting goals, then the agency resolves the conflict internal to the agency, giving primacy to the goal it deems most important

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What is conflict resolution strategy of EU?

- Has set up a structure that externalizes the goal conflicts at EU level
- Problem comes from lack of efficient mechanisms to resolve external conflicts – relies instead on calls for cooperation and information sharing to avoid problems- but will it work? US experience suggest this is risky strategy
- At individual country level there is a mix of internal and external goal conflict resolution depending upon roles of central bank, supervisors, and structure of deposit insurance funds
  - This means that faced with same set of policy issues, resulting structure will be different – hence leading to external conflict – at EU level- that will have to be resolved.

EU Regulatory Design Has Five Areas Where Conflicts Are Likely to Be Important - Especially in Cross-Border Banking

- Decentralized Deposit Insurance Design with Funding Uncertainties
- Decentralized Apportionment of Supervisory Responsibilities Between Home and Host Country
- Decentralized Safety net - LLR
- Structure of Bankruptcy Resolution
- Loss sharing – subject of Goodhart-Schoenmaker paper

Agency/Goal Problems Particularly Acute in In Failure Situations

- Home country may close institution without regard for host country effects
- Deposit insurer may favor home country depositors to detriment of host country
  - Equal v unequal treatment of claims
  - Domestic depositor preference
  - Problems of loss allocation
- Host country may incur losses due to operation of LLR which impose costs on its citizens on behalf of citizens of other countries
- Will information be shared by home country to allow host country to assess financial condition re LLR?
- Will home country be inclined to forbear?

No EU Structure to Resolve Conflicts

- Result in external regulation to deal with problems
- Ultimately fall to European Commission
  - But is it well suited to deal with these conflicts in timely fashion?
- Problems will become more acute and difficult because of widely dispirit financial systems of new EU entrants.
- Root problem is that regulatory structure no longer matches up with operational structure of institutions which are operating cross border banking operations – Nordia Bank

How to Resolve These Issue Conceptually?

- Need clear perspective on what goals are
- Need understanding of where conflicts may arise
- Need mechanism for resolving conflicts
- Minimize solutions that involve external conflict resolution (political solution) when a crisis arises

In case of systemic risk – need to define issues

- Lack of access to deposits
  - Most EU deposit insurance schemes aren't require to pay out immediately
  - Typically requirement is 3 mo. Or less
  - Most critical when institution is not reopened in timely fashion
- Loss of access to lending facilities
  - When opening is delayed
  - When there is lack of alternatives
- Payment system problems may arise due to spillover effects of above problems to other banks and real economy

Alternatives

- Structured Intervention and Early Resolution and Effective PCA to make failure isolated events
  - Prompt Legal Closure before net worth goes to zero
  - Prompt estimation and allocation of losses
  - Prompt reopening of large banks
  - Prompt re-privatization and recapitalization
- Need to focus on preventing losses
  - First key step is to get common bankruptcy process for banks