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Burden Sharing in a Banking Crisis in Europe

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Overview

1. Why burden sharing?
2. Burden sharing: two mechanisms
3. Decision-making
4. Conclusions

1. Why burden sharing?

- European financial supervision and the fiscal competence for recapitalisation are interrelated
  - “he who pays the piper calls the tune”
- Emergence of cross-border banks
  - how to deal with a failure?
- Assumption: recapitalisation is only desirable if social benefits exceed the costs of recapitalisation

Who is responsible for funding a recapitalisation?

1. Home country, because of home country control, or

2. Each country pays its own share, because of host country responsibility for financial stability

Common, but false?, assumption

- Doubtful whether home country will pay for foreign depositors
  - Political: cross-border transfers are not popular
    - example: Lux subsidiary of Banco Ambrosiano in 1982
  - Acute problem for large banks in small countries
- Under national arrangements cross-border externalities are not (sufficiently) taken into account
- Improvised co-operation (= current EU situation) leads to an undersupply of recapitalisations

2. Burden sharing

Designing burden sharing (*ex ante*) mechanisms:

- All countries pay (relative to their size) or only involved countries (relative to the presence of the problem bank)?
- Fixed key to share burden or flexible key (accommodating specific circumstances)?

Mechanism 1: General fund

- European Deposit Insurance Fund to shoulder burden of recapitalisation
- During crisis: ECB issues bonds
- Annual servicing costs of bonds paid out of Fund
  - costs born by governments and
  - financed by part of seigniorage of ECB
- Use ECB capital key for relative shares

General fund - assessment

- ✓ Smoothing over countries and over time
- × International transfers between countries
- × Adverse selection: weak banking systems
- × Moral hazard: weak supervision
- × Free rider problem: countries may not want to sign up (financial stability is a public good)

Mechanism 2: Specific sharing

- Only countries in which bank is present share in the burden
- What key to use for relative presence of problem bank in different countries?
- Relate key to objective of rescue:
  - Assets: yes, real effects (credit) and contagion effects (size)
  - Deposits: no, because mandatory deposit insurance

Specific sharing - assessment

- ✓ No international transfers between countries
- ✓ Incentive compatible: fiscal principal will ask supervisory agent optimal level of effort
- ✗ Free rider problem: countries may not want to sign up
  - Problem is worse for UK with London as financial centre (24% of banking assets in UK, while 17%/14% of GDP/ECB capital key in UK)
- ✗ Gaming on the key: use last audited figures on assets

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Overall assessment

- Costs and benefits are better aligned in the specific scheme: each country pays for the problems in its own country

- Specific scheme is better able to overcome co-ordination failure (i.e. no rescue)

General issues

- Need for legally binding arrangements
  - So, MoUs (non-binding) will not work
  - But European jurisdiction can be used
- We are left with externalities in the rest of the world
  - Truly international banks (HSBC, UBS, SBC)
  - Foreign banks head-quartered outside Europe

3. Decision-making

- **Guiding principle: “he who pays the piper calls the tune”**
- **If recapitalisations on national basis: national supervision**
- **Current set up: national gov’s and ncb’s (not ECB)**

European framework

- European bodies
  - CEBS (supervisors): severity of banking problems
  - ECB General Council (central banks): make a proposal for rescue (lolr or recapitalisation)
  - EFC/ECOFIN (governments): vote on use of taxpayers money
  - European Commission: DG Market + Competition
- In tandem with involved national parties
- Ad hoc or fixed format?
  - Number of pan-European banks is increasing
  - European bodies can ensure that rules are followed

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4. Conclusions

- Doubtful whether home country will pay on its own
- Not possible to bargain on burden sharing *ex post*
- Burden sharing has to be *ex ante* agreed:
  - General sharing: cross-border transfers
  - Specific sharing: better alignment of costs and benefits
  - But free rider problem, if not all countries join
- Recapitalisation and lolr need fiscal back-up
  - Fiscal and supervisory arrangements should move in tandem