



EUROPEAN CENTRAL BANK

Discussion of “Burden Sharing in a Banking Crisis in Europe” by Charles Goodhart and Dirk Schoenmaker

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Disclaimer: Any views expressed are only the authors’ opinions and should not be regarded as official views of the ECB or the Eurosystem

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Introduction

- Probability of **bank failures** should be at “socially optimal” level
 - Risk management is primary defence line
 - Prudential regulation and supervision against market failures
- Banks should be able to fail and **bail-outs** avoided
- They do, however, happen
- The issue is how their potentially large costs are shared in a world where the responsibility for and effects of bank failures spread across countries
- The paper discusses this issue, proposes two potential arrangements for burden sharing and addresses the decision making process in a crisis
- It is an **important contribution to the policy debate that provides two very useful benchmarks** for it

The European context

- Home country principle in cross-border supervision
- Improvements of prudential supervision: Basel II/Capital Adequacy Directive: Idea of the “consolidating supervisor”
- MoUs between different supervisors concerning specific cross-border banks/supervisory colleges
- Banking Supervision Committee meeting at the ECB
- Lamfalussy Committees in banking, in particular CEBS
- Responsibility of the ECB for monetary policy and open market operations (lending to the market)
- Emergency liquidity assistance to individual institutions
- MoUs on crisis management (guiding principles)
- Best practices, operational networks, crisis simulation exercises

Relation to the governance of central banks

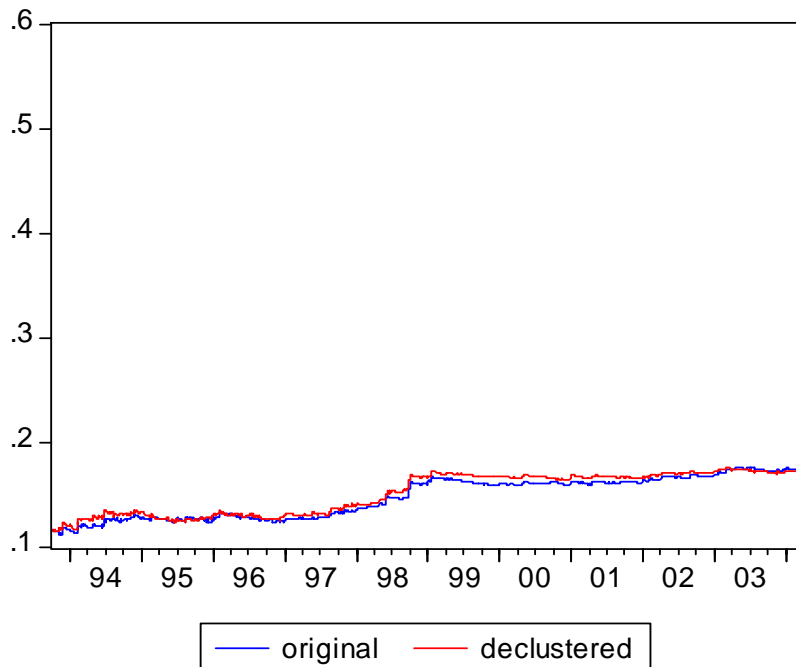
- Very complicated: Not one firm/institution with one set of owners, one (or two) decision-making bodies, single management structure, clearly defined resources and bankruptcy procedures
- Multiple institutions with different roles and decision-making bodies, complicated even at the national level
 - Prudential supervisor
 - Central Bank
 - Deposit insurance fund
 - Ministry of Finance
- Agency and incentive issues are overwhelming
- **Central bank only part of this complex governance problem**
- One of the most controversial issues in central banking

One fundamental issue: Contagion effects

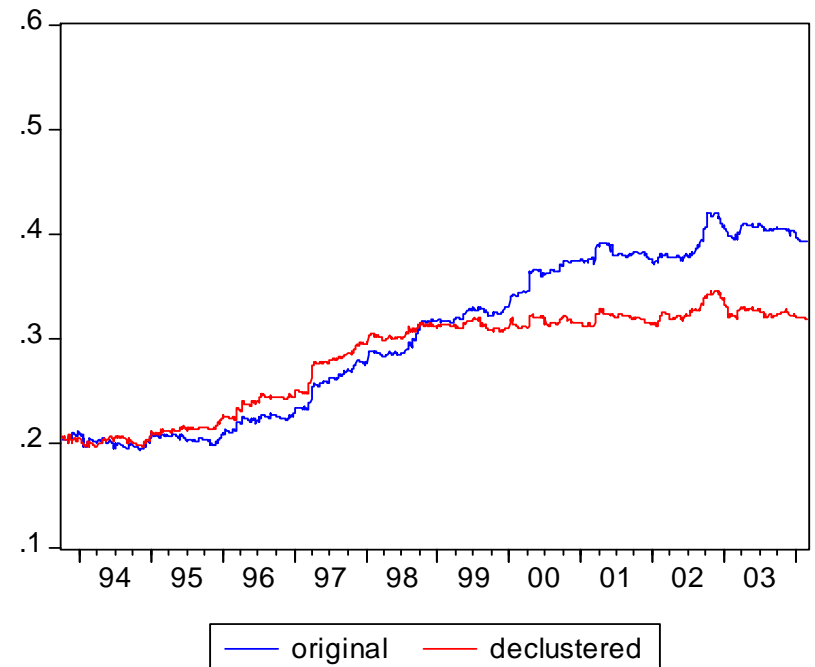
- The **extent of actual contagion** is also controversial
- Maurer and Sheldon (*Swiss Journal of Economics*, 1998) summarise the problem very nicely but provocatively:
 - *Systemic risks are for financial market participants what **Nessie, the monster of Loch Ness** is for the Scots (and not only for them): Everyone knows and is aware of the danger. Everyone can accurately describe the threat. Nessie, like systemic risk, is omnipresent, but nobody knows when and where it might strike. **There is no proof that anyone has really encountered it, but there is not doubt that it exists***
- We know with **greater certainty that macroeconomic shocks cause banking crises** (theory different?)
- The authors refer to cross-border assets
- This is only a factor/indicator of contagion risk and not evidence of or an actual measure of contagion

Bank spillover indicator based on EVT

Euro area ($N=25$)

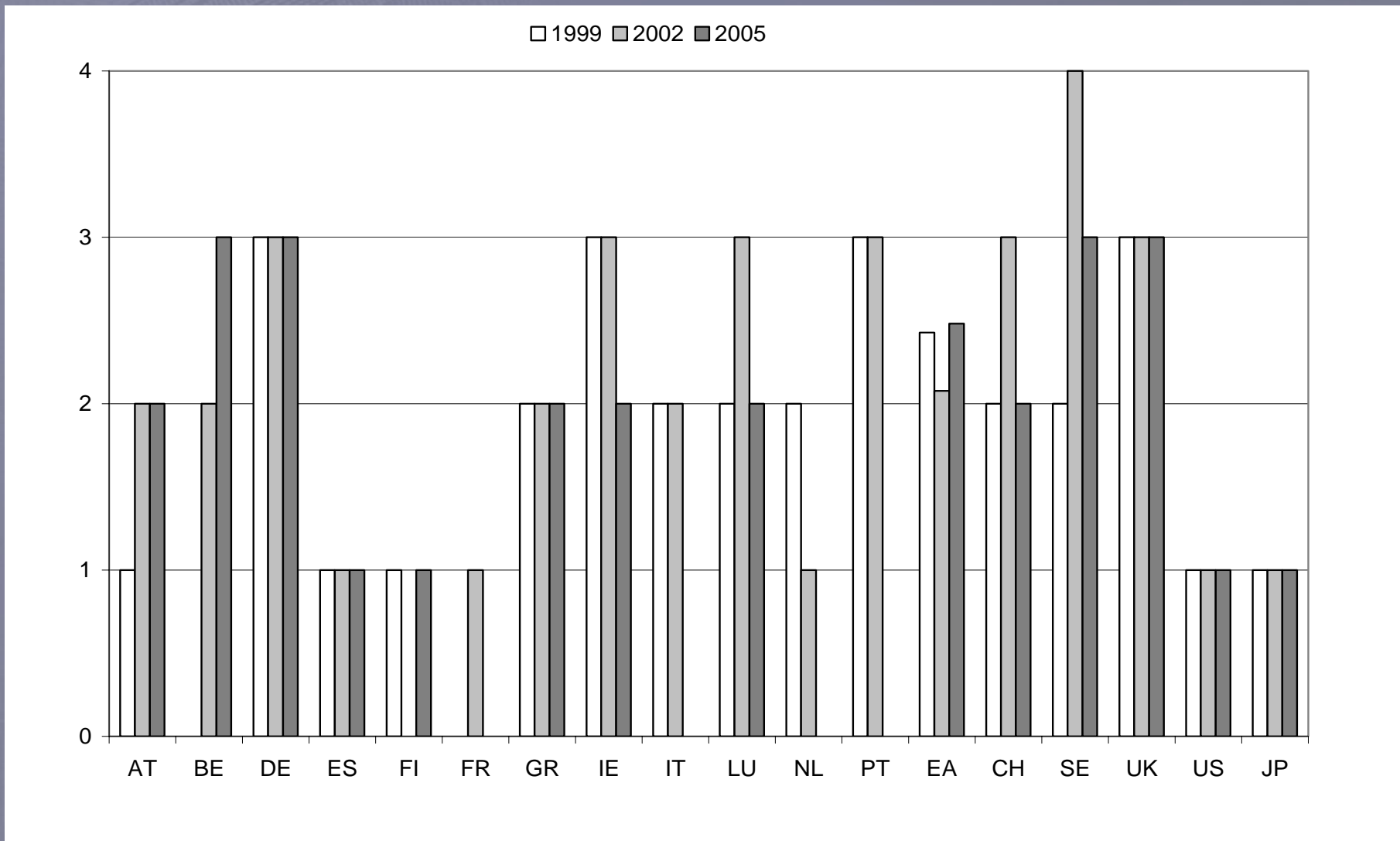


United States ($N=25$)

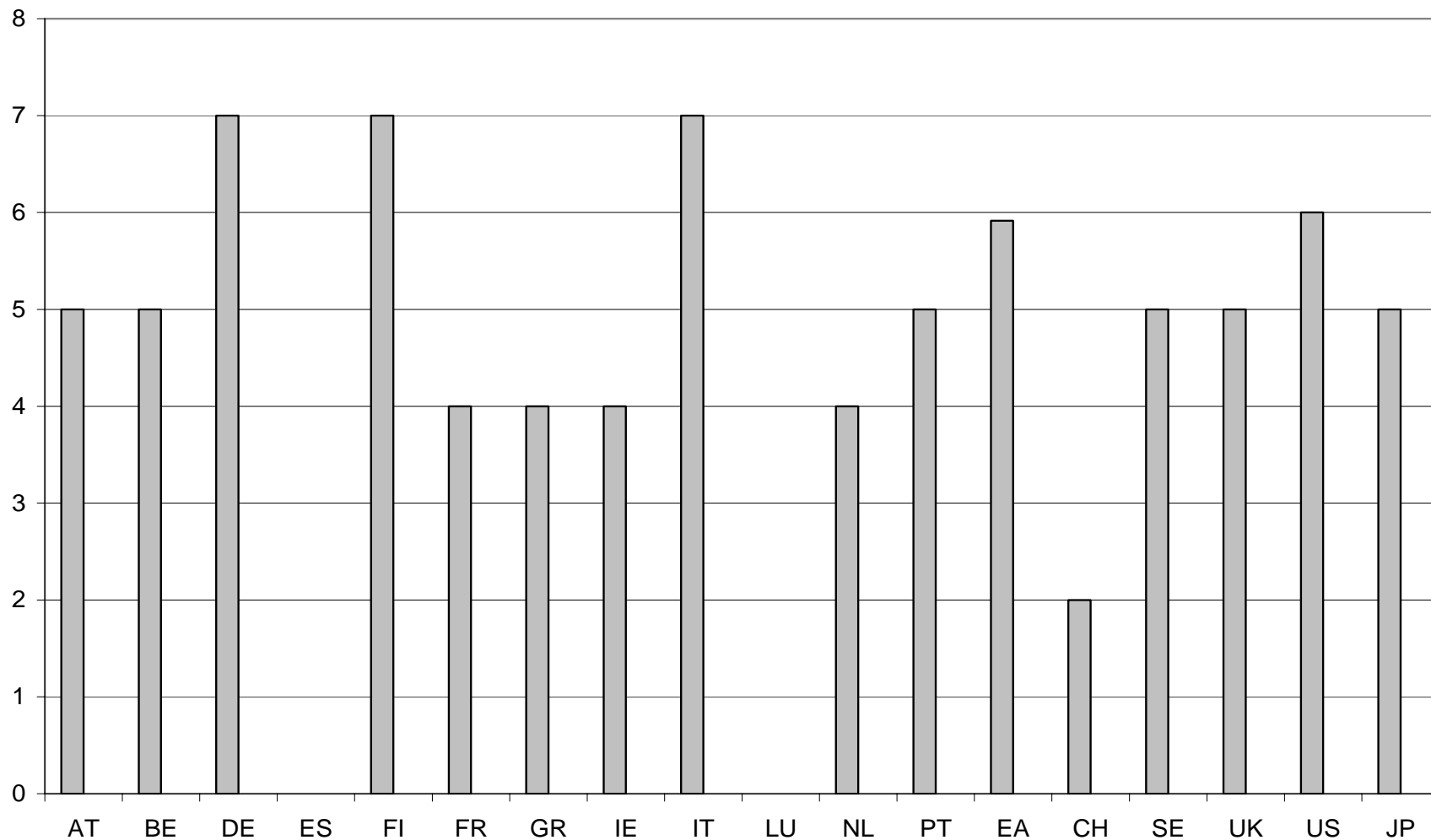


- Spillover risk is higher in the US banking system (consolidation?)
- But not the case for individual euro area countries
- It increases on both sides of the Atlantic (but euro area gradual)

Underprovision of support? Forbearance



Underprovision of support? Deposit insurance



General burden sharing scheme

- Important to know it as a benchmark, but very likely it can't fly
- **Countries pay** that have nothing to do with a problem (too early for Europe)
- Is the ex-post funding of the proposed scheme a circumvention of EU **state-aid rules**? Is it legal?
- **ECB** as a “burden sharing clearing house”?
 - Institution with “European spirit” (exists since 1999)
 - Could probably develop the expertise and process funds relatively easily
 - But the old question: Are there any reputation risks?

Specific burden sharing scheme

- Faces probably less severe objections than the general scheme
- Subsidy for London necessary?
- **UK** actively pursues to be the “banker of Europe” and has large benefits from it
- **Other measures of contagion risk** better than assets?
- Interbank exposures: Data initiative among central banks?
- Is it **sufficiently aligned with home country supervision?**
 - If the foreign country has to pay the costs of resolution in relation to the assets it hosts, will the home supervisor lower her efforts to monitor foreign branches?
 - The foreign supervisor could have now more incentives to monitor them, but he does not have the competence to do so
- Could the link between crisis prevention and resolution be improved?

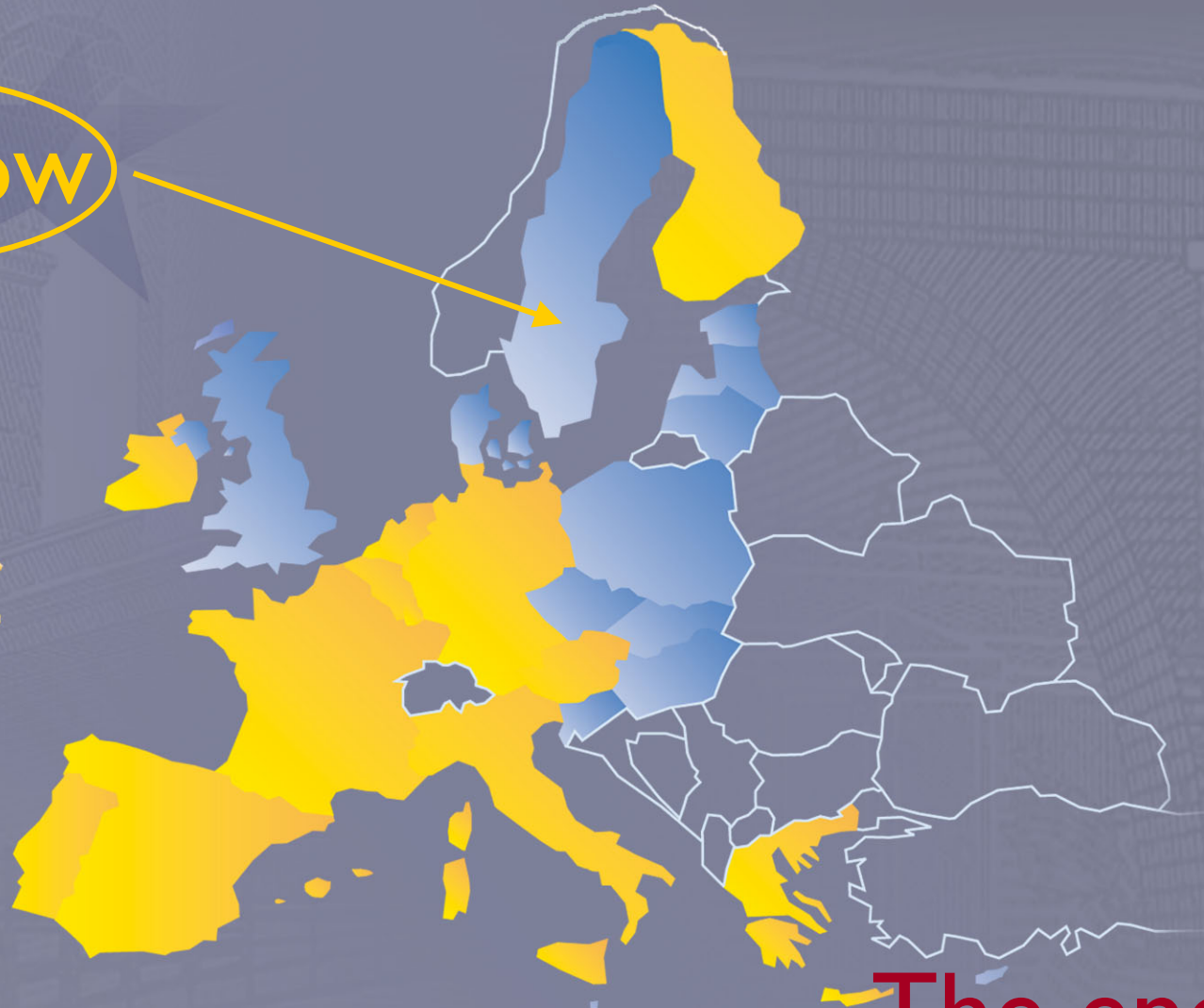
Conclusions

- Important and timely topic
- Interesting discussion of two leading experts in this debate
- Paper provides **two very useful benchmarks** for the discussion
- Crisis prevention has to be considered together with crisis resolution
- Big question: How to **align crisis prevention** structures **with crisis resolution** structures?
- Probably more work can be done
- Comparison with an alternative scheme: MoU for each large cross-border group could include the fiscal side, which would however have to be subject to “harder law”



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Be yellow



The end

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