How to Prevent and Better Handle the Failures of Global Systemically Important Financial Institutions

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1. Introduction

When the dust settles and the final numbers are tallied up, it should be no surprise if the massive support provided in the (ongoing) crisis to banks and other financial institutions – directly in the forms of assistance from governments and central banks, and indirectly through support from international organizations, including to sovereigns under stress – has meant that taxpayers, especially in Europe, have engaged in the largest cross-border transfer of wealth since the Marshall plan. The crisis has also shown that the ad-hoc solutions typically used to deal with failed globally systemically important financial institutions (G-SIFIs)[2] lead to much turmoil in international financial markets and worsen the real economic and social consequences of crises.

Importantly, events have made abundantly clear (again) that, for all the efforts invested in the harmonization of rules and agreements to share more information, supervisors had little incentives to genuinely cooperate before the crisis and did too little to help prevent the weaknesses and failures of many G-SIFIs. Together, these facts, and the ongoing turmoil in Europe and elsewhere, remind us of the high costs from not having a system that can effectively and efficiently deal with G-SIFIs under stress.

A better approach to dealing with G-SIFIs is thus sorely needed. Many policy efforts are underway (by individual countries, the Basle Committee on Banking Supervision, the Financial Stability Board, the IMF, and others) to strengthen regulatory and supervisory frameworks, improve the robustness of these institutions, and enhance actual supervision internationally to prevent distress. At the same time, any approach has to be based on clear analysis of the underlying problem and not on wishful think(er)ing. Logic suggests starting from the endgame, i.e., resolution, the process of how a weak financial institution is (in part) liquidated, closed, broken up, sold, or recapitalized. Specifically, the rules governing who is

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[2] While it is hard to define exactly what a G-SIFI is, and there can obviously not be a final list, the FSB (2011) lists 29 "G-SIFIs" for which certain resolution-related requirements will need to be met by end-2012.

in charge of the restructuring and liquidation process and how losses are allocated when a G-SIFI runs into trouble are crucial. The endgame strongly affects supervisory incentives and market behavior long before difficulties arise. And the endgame rules affects the time-consistency problem whether or not an ad-hoc bail out is ex-post the most efficient solution.

As policy makers realize all too well, however, especially in Europe today, approaches to resolution of G-SIFIs can conflict with three other policy objectives – preserving national autonomy, fostering cross-border banking and maintaining global financial stability. These three objectives are not always mutually consistent – i.e., they create a *financial trilemma*, and approaches to resolution have to operate within this *trilemma*. In this paper I examine the causes for the resolution problem of G-SIFIs and review three approaches to improving cross-border resolution which address the *financial trilemma* head on acknowledging solutions are to be found in partly giving up fiscal and legal sovereignty or putting restrictions on cross-border banking.

2. Diagnosis of the Current Problem

The recent financial crisis has had multiple causes, with their relative importance still being debated (for analyses and views, see the financial crisis issues of the *Journal of Economic Perspectives*, 2010, Winter and Fall; 2009 Winter). One of the (approximate) causes, however, surely was the behavior of G-SIFIs (Claessens, Herring and Schoenmaker, 2010). In part because of weak oversight, G-SIFIs took too much risk before the crisis. And during the crisis, a relatively small group of thirty to fifty G-SIFIs became important causes for financial turmoil and channels for cross-border contagion. Both through direct links – as in case of interbank exposures – and through other channels – such as affecting asset prices and other financial markets and threatening essential financial infrastructures, such as payments system – their actions and financial problems added to the overall real costs of the crisis.

Aggravating the financial turmoil and creating large fiscal and real costs were the interventions in and support for weak G-SIFIs. Many G-SIFIs have been the recipient of much direct public support – in the forms of explicit guarantees and official recapitalization – and other forms of (implicit/indirect) support – as when G-20 governments explicitly announced in the fall of 2008 that they would be protected or when central banks provided more ample liquidity. This support has been very costly, as in other crises, and, while often hidden from the public view, has involved large transfers between countries. Examples include the payouts made to foreign banks as the U.S. government provided support to AIG, public support to international banks like RBS, ABN-Amro and the like, and the large implicit transfers – through the ECB and other official support – to the sovereigns and banking systems of crisis-affected countries, such as Greece, Ireland, Portugal and others.

In the aftermath of the crisis, reform efforts are focusing on how to make G-SIFIs more robust to shocks and less prone to insolvency (by higher capital adequacy and liquidity requirements and surcharges, and better liability structures). These reforms are desirable. They can, however, come with some drawbacks – in the form of higher costs of financial intermediation

– and may not necessarily make the systems more robust – as they can create incentives for more risk taking and lead to risk shifting to other parts of the financial system (e.g., shadow banking system), in the process creating new systemic risks. Importantly, while much is being done to improve the (international) supervision of G-SIFIs, many of the supervisory challenges will remain as long as there exist deficiencies in frameworks for resolving G-SIFIs and when resolution is internationally not consistent. This view becomes obvious once one considers the state of international financial integration and works backwards from the endgame of resolution.

Countries have become increasingly intertwined financially as cross-border claims have grown much faster than trade and GDP. Much is this is due to a small number of G-SIFIs that operate across the globe. Many of these institutions are very complex (Herring and Carmassi, 2010): on average, for example, the top 30 G-SIFIs have close to one thousand subsidiaries, of which some 70% operate abroad and some 10% in off-shore financial centers (Claessens, Herring and Schoenmaker, 2010). Complexity makes many G-SIFIs not only difficult to manage, but can also cause them to have systemic consequences. Importantly, a SIFI can be very difficult to wind down and become "too big to fail". Many, not just the G-SIFIs themselves, argued during the crisis that if a G-SIFI deeply involved in a wide range of countries were permitted to fail, this would have repercussions that affect financial systems and national economies around the world. And indeed, as noted, many G-SIFIs were supported for this reason, as it was (considered to be) ex-post the most efficient. And those few that did not get support, created great havoc in international financial markets.

What to do going forward when a G-SIFI runs into difficulties and potentially needs to be resolved has thus become of crucial importance to a safer global financial system. Clarity about the responsibilities in the resolution stage, including the allocation of any costs, greatly matters for the incentives of relevant stakeholders in the preventive stages. These stakeholders importantly include, besides various financial market participants, the multiple supervisors responsible for G-SIFIs. By insufficiently focusing on the need to improve the frameworks for cross-border resolution, i.e., the endgame, however, they may have failed to address the deeper problem. That this big lacuna is yet to be rectified is not surprising given its causes.

National authorities will have a natural inclination to focus on the impact of a G-SIFI failure on their domestic systems (i.e., just considering national externalities) and to ignore the wider impact on the global financial system (i.e., the cross-border externalities). The dominance of the national perspective arises for two reasons (Freixas, 2003). First, the financing typically required for dealing with a weak G-SIFI, and any direct costs associated with final resolution, are borne by domestic taxpayers. Second, insolvencies and bankruptcies are dealt with by national courts and resolution agencies that in turn derive powers from national legislation. The resolution of G-SIFI can then lead to coordination failures, where each national authority only looks after its own interest and nobody addresses the global interest.

Similar to the trilemma in international macroeconomics of a fixed exchange rate, independent monetary policy and free capital mobility (Rodrik, 2000), a trilemma arises in dealing with G-SIFIs. This *financial trilemma* (Schoenmaker, 2011) implies that three policy

objectives – preserving national autonomy, fostering cross-border banking and maintaining global financial stability – are not always mutually consistent. Solutions to the trilemma are to be found in giving up partly fiscal and legal sovereignty or putting restrictions on cross-border banking. So far countries have not chosen in a coherent manner, leading to problems.

The theoretical possibility of co-ordination failure is born out in practice. In most cross-border bank failures during the recent financial crisis, there was no, or at best partial, coordination, which undermined confidence in the international financial system and increased the costs borne by domestic taxpayers. The failures of Fortis, Lehman and the Icelandic banks illustrate how damaging the lack of an adequate cross-border resolution framework can be for global financial stability. The restructuring of many G-SIFIs done on a national basis led to major disruptions. The ongoing restructurings of European banks (and sovereigns) in periphery countries (Greece, Iceland, Ireland, etc.) involve large (implicit) transfers, motivated in large part by desires to preserve (regional) financial stability, and show the difficulties in achieving coordinated solutions. Only in some cases have authorities reached a cooperative solution, as when they facilitated the continuation of Western bank operations in Central and Eastern Europe, with relatively good outcomes. In the case of Dexia, which appeared for some time to have been a good cooperative solution, the bank ended being dissolved.

3. Possible Solutions

To date, international supervisory efforts have focused on harmonization of rules and increasing supervisory cooperation, while resolution – the endgame – has been largely neglected. The crisis shows this approach is wrong. For all the harmonization, supervisors had little incentive to really cooperate, exchange information and intervene in a coordinated manner. Rather policy-makers addressed most weak financial institutions on their own, often with little regard for international consequences. A better solution is to start from the endgame, resolution, since who is in charge and how losses are allocated strongly affect incentives and behavior long before difficulties arise.

Most countries though lack an effective framework for resolving even purely national financial institutions. All too often – as in the recent crisis, the endgame is instead determined under crisis conditions through frantic improvisations over a chaotic weekend, with often no choice but to rescue the institution at great cost. The internationally operating SIFIs make this a global problem. While national reforms have to be the starting point, there are three reform models that can help address the global problem. The first two are corner solutions. The third is an intermediate approach.

The first reform model is a territorial approach under which assets are ring-fenced so that they are first available for resolution of local claims. There is no need for burden sharing or coordination, as each country manages the resolution of its own part of the cross-border SIFI. This approach creates inefficiencies – a financial institution has to manage capital and liquidity separately in each country – and compromises the cross-border integration

dimension of the financial trilemma. I reject this approach given the benefits from and the de-facto state of financial integration.

The second reform model is a universal approach under which all global assets are shared equitably among creditors according to the legal priorities of the home country. This approach can be combined with agreements for burden sharing between countries, including through some form of financial sector taxation (see Claessens, Keen and Pazarbasioglu, 2010), which can further strengthen the incentives for coordination in resolution and supervision. In this model, in terms of the financial trilemma, national autonomy is partly given up. This universal approach is probably only feasible and desirable among closely integrated countries, such as those in the European Union.

The third reform model is a modified universal approach, i.e., an intermediate approach to address the financial trilemma. The modified universal approach implies countries need to adopt improved and converged resolution rules and require G-SIFIs to have better resolution plans. While not giving up national sovereignty, countries do need to agree to expand the principles for international supervision and they could adopt an enhanced set of rules governing cross-border resolutions (as in say a new Basle Concordat on "Coordination of Supervision and Resolution of Cross-Border Banks").

Of the three approaches to the resolution of G-SIFIs that address the trilemma, the universal approach may be feasible, but only among closely integrated countries. The territorial approach impedes efficient international financial integration, but is actually what in many countries the local regulators of the different parts of a G-SIFI appear requiring to do. Attention is largely focused on these two options, but they represent either end of a spectrum, and neither can work effectively in general. More realistic for most countries is a modified universal approach, which requires G-SIFIs to put in place effective resolution plans; each country to adopt improved resolution rules; and countries to jointly adopt a set of rules governing cross-border resolutions that enhance predictability of official actions in a crisis and increase market discipline before crisis conditions emerge.

For all approaches, there will be a need for a new paradigm in international policy coordination. Efforts should move from "can" national authorities cooperate in international supervision and resolution, as reflected in the current harmonization model, to "will" national authorities cooperate. This will require adopting a much more incentives-based approach, integrating regulation, supervision and resolution policies, and enshrined in a new Concordat. With this, the global financial system can become more predictable and safer, resolution in a crisis more efficient, and through enhanced market discipline, crises less likely.

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