Questions for Discussion – some suggested thoughts

1

- Is competition among regulators good or bad for prudential management of banks and for financial stability?

The issue here is whether competition leads regulatory authorities to get a reputation for being easier on banks so that they can increase the number of banks they supervise and hence their revenues or whether it leads to pressure to set higher standards so their banks have a better reputation with their customers. Evidence from the US is mixed and certainly there have been examples of slacker regulation. At present however one of the complaints that the UK has about the new system is that they would prefer to set higher standards so that London has the reputation of being the best banking centre in the world. Certainly where they do have a choice in ring-fencing retail banks from riskier activities, they have exercised it.

- Is enough effort being spent on crisis avoidance rather than crisis management?

There is no obvious answer to exactly what the balance should be as in part it is a trade-off between risk and growth in the economy. In justifying the BRRD the European Commission has attempted a cost-benefit analysis of the various measures, looking at the relative merits of the higher capital requirements, the higher deposit insurance and the introduction of bailing in. Bailing in comes out with the greatest benefits, with the better capital standards offering limited gain. In part the problem is that improved resolution procedures will themselves act as an incentive for banks to run themselves better. With bailing out being the expected outcome for large banks – i.e. those deemed too big to fail –this could easily induce moral hazard. This is certainly view of the RBNZ who argue that the main gains from OBR are going to be in encouraging banks to seek other solutions since management and shareholders will lose so much under OBR.

However, the cost of the GFC has been very large, so spending only a small amount more on early warning systems and other means of heading a crisis off might seem a small price to pay. The problem is that avoidance measures have a cost whether there is a crisis or not, whereas crises only have a cost if they happen. It is very difficult to argue whether measures have led to avoiding crises. It is only the opposite which one can see readily which is when they have failed to avoid one.

- According to the Financial System Inquiry Australia should aim to be in the top quartile of advanced countries capital standards – i.e. above the EU. Where should New Zealand aim to be?

It is not immediately clear that relative standards are the way to look at this problem. If other countries set standards too low or too high there is no reason why one should copy them. However, if the external standard is set correctly there is an argument that New Zealand should exceed it because it is a small economy open to a wider range of shocks and with less opportunity to diversify. Furthermore the IMF criticises its banks for being too dependent on overseas finance – something one might want to contest as that is an inevitable consequence of having foreign banks. On the other side of the coin, the Australian banks run a fairly conservative business and *there is not much non-retail risky activity and use of exotic products. Furthermore one might argue that the Australian authorities will ensure that their banks will be safe so that New Zealand need not worry much. That said, New Zealand does set relatively high capital standards and certainly higher than Australia with overlays for mortgage and agricultural lending.*

2

- Will omitting the UK from the SSM help the SSM succeed or lead to a greater split in Europe?

This is a complex question as it will depend on both how the SSM and UK authorities run their supervision but having the UK outside the game must surely reduce the flow of relevant information available and make consolidated supervision more difficult. Drawing a dividing line on the basis of membership of the euro area is clearly irrelevant and any divisions should be based on the structure of cross-border banks. On that basis it is difficult to think of any reasons why the UK should be on the outside. It is understandable that they do not wish to be in a system run by the ECB which is likely to concentrate power in Frankfurt rather than London. If an independent supervisor based in London could be set up then they might go along with it.

- Is there a better system that could be envisaged?

In part the previous answer addresses this. All of the EU/EEA should be in the inside and the supervisory arrangements should include the whole of banking groups and not just the banking part if risks are to be managed and the advantages of diversification offset against the higher risks of some other activities.

- Is it a mistake to have the ECB running banking supervision?
    - Will it conflict with monetary policy?
    - Could it damage the ECB's reputation?
    - Will it politicise the ECB?

The answer to all these questions is likely to be yes but this does not imply that the ECB will do a poor job. On the contrary it will want to keep its reputation and try to ensure that banking supervision is run well across the whole of the euro area. Having a dual mandate for financial and monetary stability always runs the risk of a conflict but the better information that the ECB gets from supervision may help in the running of monetary policy and hence act as an offset.

A look at other jurisdictions shows that banking problems can harm central banks reputations. The Bank of England was heavily hit by the BCCI and Barings scandals. This applies generally to regulatory responsibilities as the Libor scandal illustrates. The worst damage would occur when the ECB fails to head off a banking problem and loses money – especially if that was largely for monetary policy reasons.

Banking union has been designed to try to depoliticise decisions with respect to large banks but it is debatable if this will succeed particularly in the large countries which have more power. The ECB will have to take decisions which will have political consequences for member states and that will be a problem. It is already noticeable that the definition of what constitutes a banking *group has been chosen so that a large number of banks in Germany (and Austria) have been excluded where such savings and cooperative banking systems have been included in other countries.*

3

- Does the BRRD give resolution authorities enough tools?

The BRRD seems to have provided almost all the powers one can think of. Indeed it is possible that there may be some conflict on the basis of human rights of shareholders when resolutions actually take place. The only obvious item that is weak is the access to taxpayer backed support for the short-run costs of resolutions as there is in the US.

- Can recovery plans be realistic?
  - Can authorities intervene early enough?
  - Will there be enough loss absorbing capacity?
  - Will bail ins generate a collapse in confidence?

There is considerable scepticism about whether a recovery plan can ever offer a believable strategy in a crisis indeed the FDIC/Fed in the US have rejected all the initial proposals from the main banks as being inadequate. If markets are not operating properly it is very difficult to say what steps will work, whether buyers can be found, new capital raised etc.

It is even more unlikely that authorities will intervene early enough on the basis of past evidence. On the one hand forbearance has been frequent because the difficulty might pass by and no one wants to admit that a bank is in trouble and then find that it could survive. At the same time the banks do their best to cover up the problems. Take the case of Northern Rock for example the authorities were slow to act and initially the Bank of England refused to provide liquidity support.

Under Basel 3 large banks have to hold excess capital both for cyclical reasons and because of their importance. They will thus be more resilient than in the GFC. Moreover, that capital now has to have a much larger element of common equity in it, which is a proper shock absorber. Already banks are issuing more debt that can be bailed in in the recovery phase – contingent convertibles (cocos) which are triggered by capital ratios and not by decision of the authorities. All this should help.

However, if a bail in is likely it will become very difficult to sell any new bailinable debt and market values will fall. Some people think this will increase the sense of crisis and bring it forward. Shareholders may also be keen to trigger the bail in to prevent them being bailed in as well. In the case of a resolution, especially under OBR then the threat of bailing in is likely to generate bank runs. However, these will be of ordinary debt including deposits and not debt which is specifically designed for the purpose. Cocos get converted into equity so the holder has a stake in the bank. If debts are just written down then people simply lose and do not have a stake in the upside. So the design of a bail in matters – whether it is a writedown or a debt for equity swap. The former is likely to cause much more instability.

- Will resolution through the SRB work?
  - Will national governments still bail out their main banks?

It is very difficult to judge how well the SRB will work and there is little evidence to go on. One might well think that as an EU level institution it will be above all the political pressures that will exist at the level of the member state. Unlike the US where there are fairly frequent failures it may be some time before we can see how the SRB acts and even then it will not be involved in the small bank which remain a national responsibility.

Bailing out is only possible if there is no element of state aid and in any case can only be performed by the member state that have low enough debt to do so. Undoubtedly the BRRD will discourage bailing out. How far is difficult to guess as the fall out from a bank failure will be large and the temptation to issue widespread guarantees to restore confidence will be substantial.

- Are the resolution funds large enough?
  - Should the ESM be used?

General opinion seems to be that the answer may be no. The funds relate to the failures of large banks where they cannot stop operating. A problem with a large bank is likely to be part of a more general crisis and hence there will be several failures occurring at the same time. Hence demands on the funds might be substantial. Ironically this is not a problem for deposit insurance as with priority it is unlikely that depositors will be bailed in. The insurance funds will only be at risk in the case of small bank failures where they will simply be allowed to go into insolvency and the BRRD tools will not be used. But in this case the funds should be sufficient unless there are many failures of small banks in a short period of time.

The circumstances where the ESM can be used are limited in the legislation. Someone has to be credibly able to pay it back. If it is to be used for simple short-run funding to be repaid from the assets in a resolution run by the SRB, this sounds reasonable. If it relates to the national authorities in an over-indebted country then it will be contentious.

4

- Should banking union be completed by harmonising deposit insurance and introducing a directive separating risky activities from retail banking?

Undoubtedly having unified deposit insurance will help so one country can draw on another if the failures are concentrated. Simply harmonisation will not be enough.

There is a substantial debate about whether risky activities should be separated and in what way. This is summarised very clearly in the Liikanen Report. The question is whether the risky activities should simply be held in separate subsidiaries or whether they should be outside the banking group altogether. Opinion tends to favour the former, although it depends how wide the definition is of activities to be excluded. In general the longer the list the less the pressure for them to be banned for banks and the more for them just to be in separate subsidiaries.

- Should the EU take the opportunity of the Treaty renegotiation required by the UK to complete banking union with a new independent supervisor who can cover the whole EU?

It should be clear from the presentation that my opinion is yes because placing the supervisory role in the ECB has two disadvantages, first the possible conflict of interest and loss of reputation and second the unwarranted confusion of membership of the euro area with membership of the SSM. All countries with cross-border banks should be able to participate in the system on an equal basis and not have one privileged group. However I doubt if it will happen. There will be too great sunk costs in setting up the ECB based system and too great conflict over where the new supervisor might be and how it would be structured. That said, the UK switched its supervisory arrangements twice in under 20 years.

- Are bail ins realistic as a resolution tool?
    - Will they avoid a systemic crisis?

Since I have been advocating debt for equity swaps and other forms of asset and liability restructuring for nearly 20 years my opinion is clear. They are an important tool in armoury and would avoid the use of taxpayer funds in many circumstances. The problem comes with large banks where the extent of the bail in is large. A bail in brings the realisation of the losses into the present and since the revived institution needs to breed confidence it has to be well capitalised meaning that the bail in will be larger than the losses. A bail out on the other hand spreads the losses very widely not just over the whole of the taxpaying population but over the future. It thus depends who is going to be doing the bailing in as to the impact. If it is hedge funds and others who can absorb the loss the impact will be limited. If it causes pension funds to fail then it will still generate a systemic crisis but by another route.

Thus bailing in can help but it usefulness should not be exaggerated. If there is a big crisis a bail in will not stop it being systemic. In the case of OBR however a bail in is not credible as it will involve depositors and it is unlikely that a government will be willing to see a large number of electors lose in the short run when it could bail out instead and make the losses seem much less important and the immediate effect on the economy smaller.