



# The Future Architecture of the Financial Safety Net in the EU

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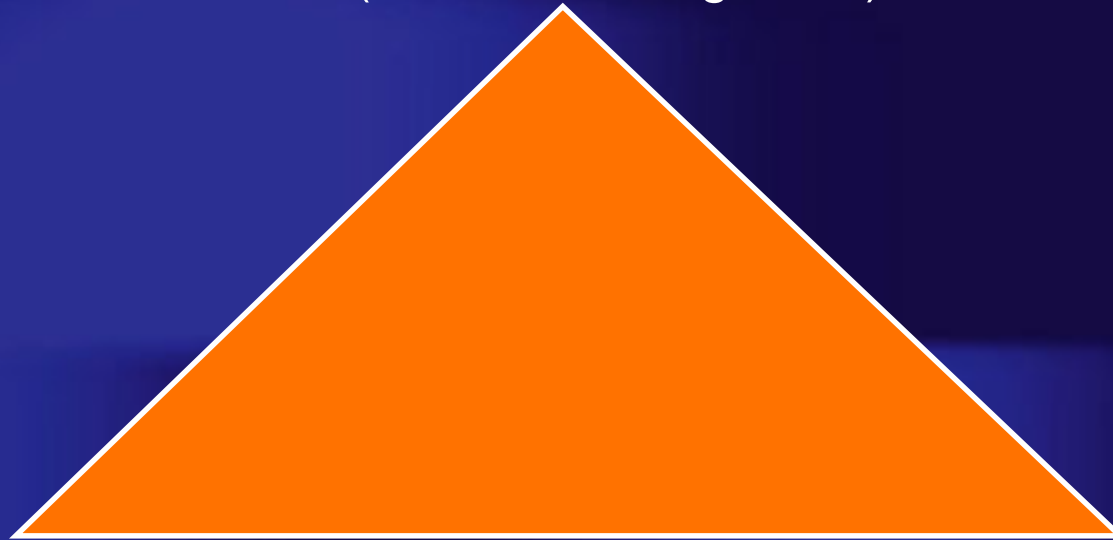
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# Overview

1. What is the problem?
2. Market developments
3. Financial supervision
4. Financial safety net (burden sharing)
5. Conclusions

# 1. What is the problem? - Trilemma

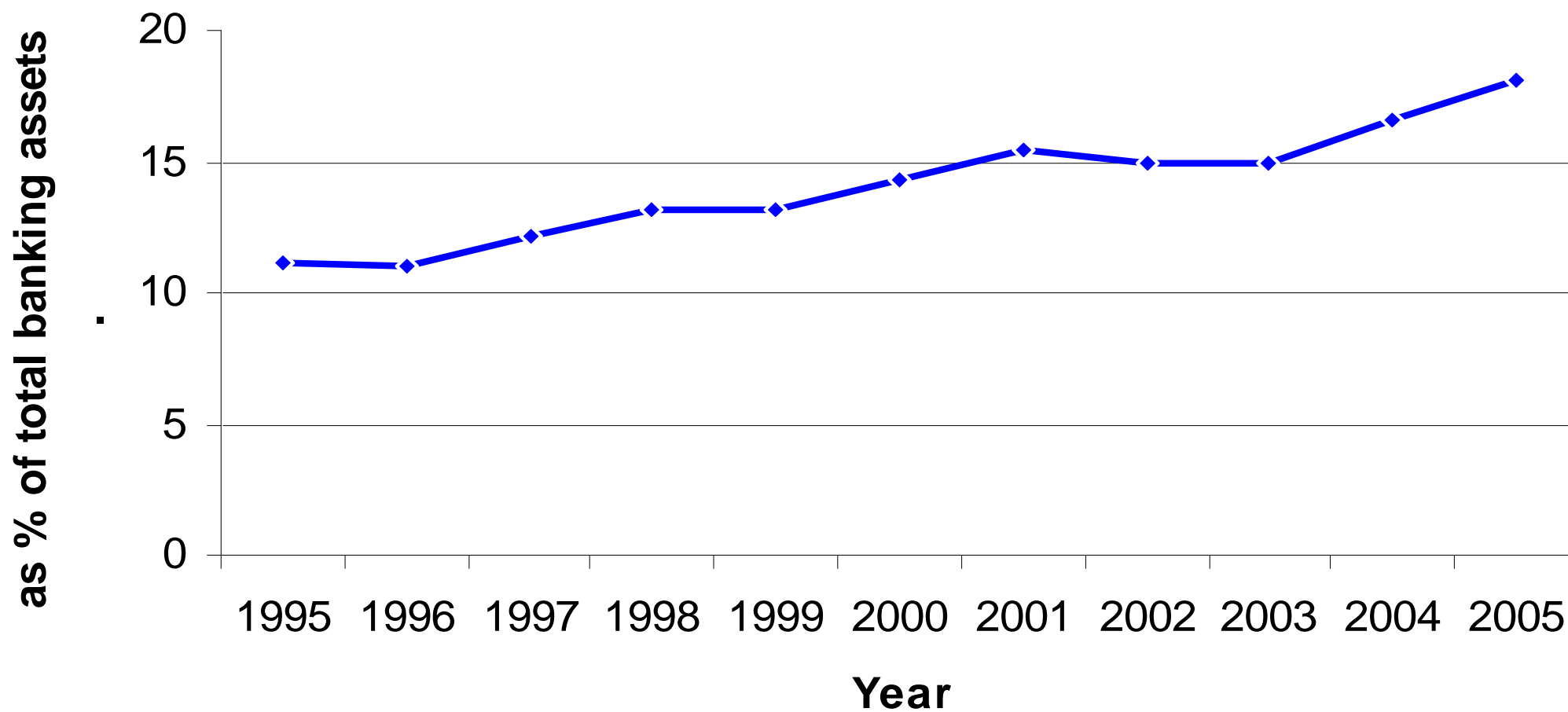
1. Stable financial system  
(stable exchange rate)



2. Integrated financial market  
(capital mobility)

3. Independent national financial  
supervision and stability  
(indep. national monetary policy)

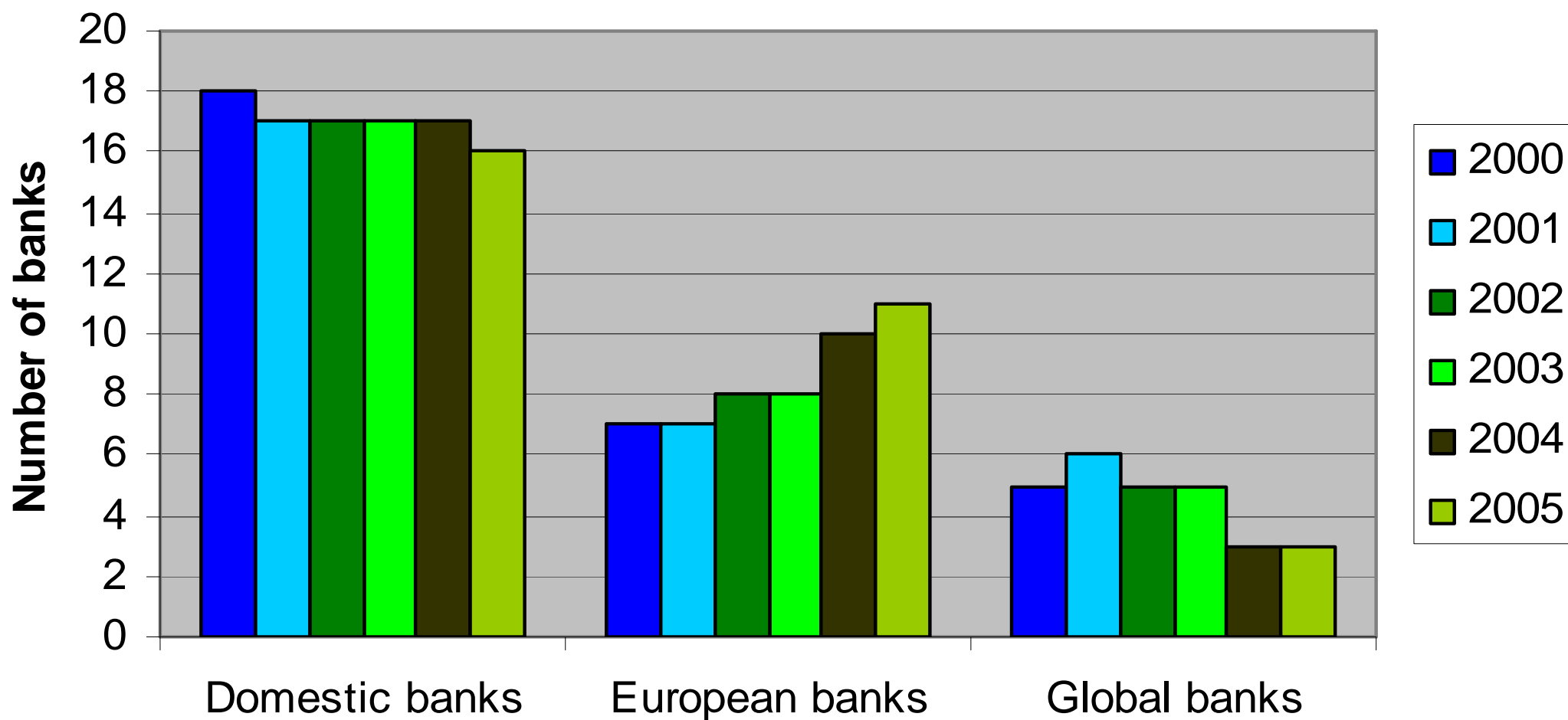
## 2. Market developments: cross-border



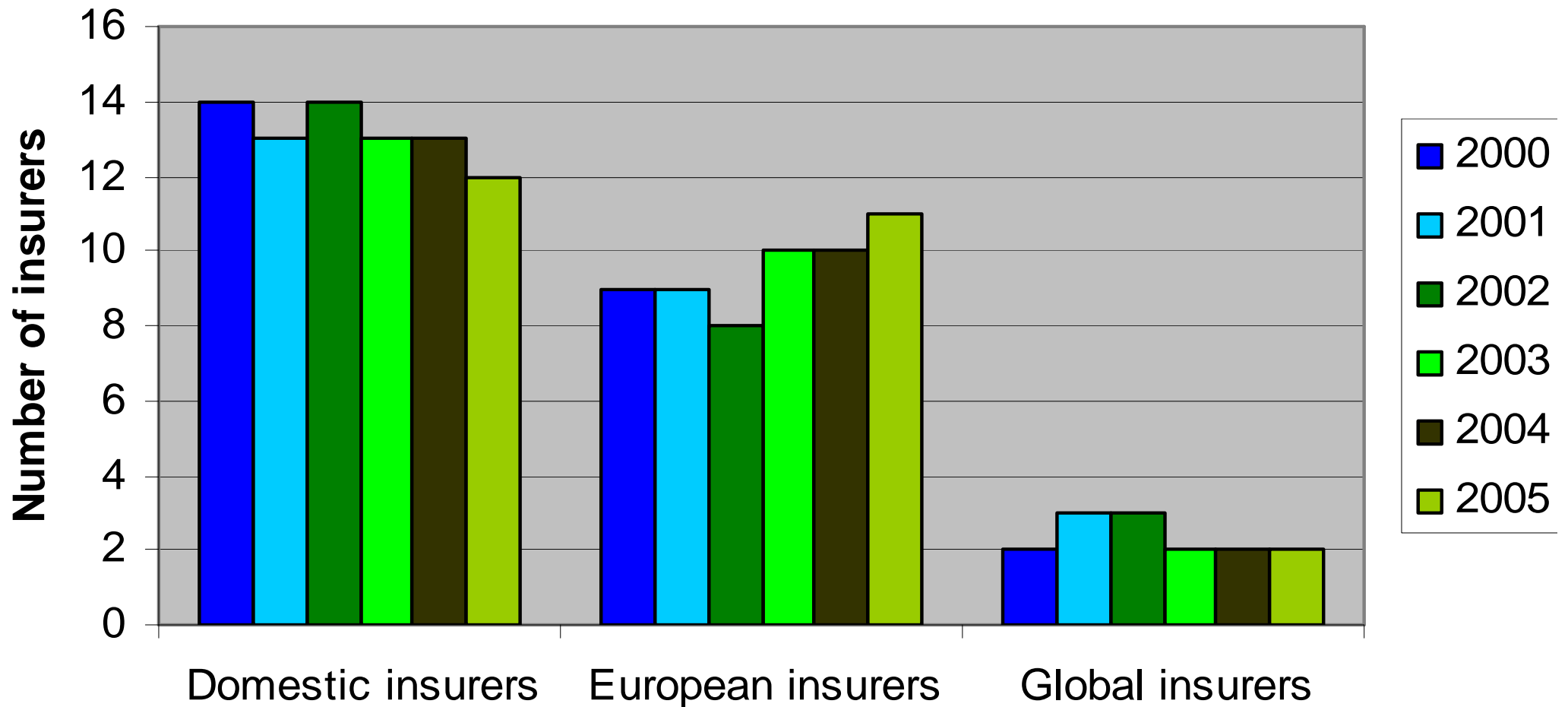
# Cross-border penetration uneven

<b>Year 2005</b>	<b>Domestic</b>	<b>From EU countries</b>	<b>From third countries</b>	<b>Total business</b>
<b>EU-25</b>	<b>74</b>	<b>18</b>	<b>8</b>	<b>100</b>
<b>- EU-15</b>	<b>75</b>	<b>17</b>	<b>8</b>	<b>100</b>
<b>- NMS-10</b>	<b>35</b>	<b>60</b>	<b>5</b>	<b>100</b>

# Top 30 EU banks (2000-2005)



# Top 25 EU insurers (2000-2005)



# Banking vs Insurance

- Insurance is more international (in particular European) than banking
- European banking is increasing over last 5 years; European insurance has already been there for a while

# Trend towards centralisation

- Centralisation of key management functions
  - Risk management
  - Capital management
  - Treasury operations
  - Internal Audit
  - Etc.
  
- Example of risk management
  - Firm-wide integrated risk management models
  - Fostered by regulation (Basle II and Solvency II)

## 3. Policy challenges

Supervisory structure should follow market developments

Market trends

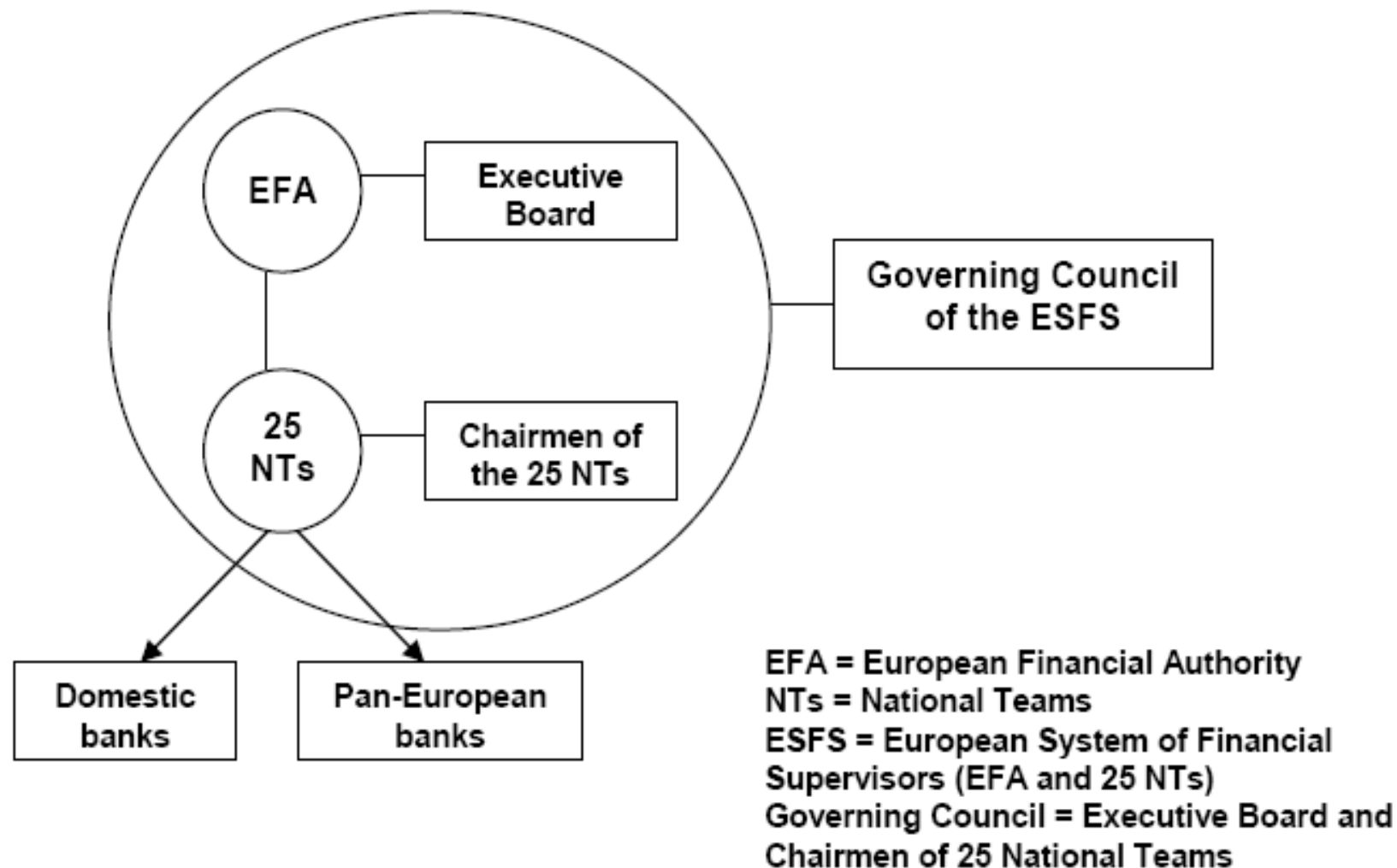
- 1) European financial groups are emerging
  - EU-wide coverage of supervision needed: challenge for cooperation between home and host
  - Undermines capacity of host country to manage financial stability
- 2) Centralisation of risk management
  - Reinforces role of home/consolidating supervisor

# Possible solution

European System of Financial Supervisors:

- National supervisors work in tandem with a central body (European Financial Authority)
- Comparable to ESCB structure

**Figure 7. A decentralised European System of Financial Supervisors (ESFS)**



# How does the System operate?

## European System of Financial Supervisors:

- Small and medium-sized banks and insurers supervised by national supervisor with a national mandate
- Pan-EU financial groups supervised by lead or consolidated supervisor (home country) with a EU-wide mandate
- Central body
  - ensures uniform application of regulations
  - has the power to overrule national lead supervisor to ensure that they operate on a EU-mandate (rather than a national mandate)

# What is the role of the host?

- Interested to hear your views today
- Important that there is input from host for two reasons
  - host knows the local conditions better
  - link with burden sharing (see later)
- Central body
  - has the power to overrule national lead supervisor to ensure that they operate on a EU-mandate (rather than a national mandate)
  - referee between home and host?

# How to get there?

- Evolution: developing new level 3 committees (CEBS, CEIOPS) into some kind of “European System of Financial Supervisors”
- Key element: centralised framework for trans-national financial groups, but decentralised day-to-day supervision
- Argument for decentralisation:
  - lead supervisors should be close to head-quarters of financial groups, where key decision-makers are located
  - host supervisors should give input and receive information

## 4. 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?
  - conflicts of interest

# Recapitalisation

- Fiscal costs of banking crises can be large: average of 13% of GDP in sample of 40 banking crises
- Private sector solution is preferred route
- 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

## First: reduce problem

- Early closure of banks (PCA) would reduce, but not eliminate need for cross-border crisis management
- Examples of early/timely closure (PCA):
  - Unlimited liability in free banking in 18<sup>th</sup>/19<sup>th</sup> century Scotland
  - FDICIA in US (Benston/Kaufman)
  - Prompt corrective action (promoted by ESFRC)

## Multi-country setting

- Freixas-model demonstrates underprovision of recapitalisation
  - Countries have incentive to understate their share of the problem
  - This leaves largest country (home) with the full cost
  - Improvised co-operation (current EU-situation): *ex post* negotiations with multiple equilibria (often no recapitalisation)
- *Ex ante* mechanisms to overcome co-ordination failure

# 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 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 (or GDP) 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

# Overall assessment

- Costs and benefits are better aligned in the specific scheme: each country pays for the problems in its own country
- No political appetite (yet) for ex-ante arrangements
- Suggestion: start with principles of burden sharing

# 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 (IoI or recapitalisation)
  - EFC/ECOFIN (governments): vote on use of tax-payers money
  - European Commission: DG Market + Competition
  
- In tandem with involved national parties (interest groups)

## 5. Conclusions

- Cross-border banking in Europe has arrived
  - Challenges for supervision and safety net
- Supervision
  - Adequate home-host cooperation
  - European System of Financial Supervisors?
- Safety net
  - Doubtful whether home country will pay on its own
  - Need for burden sharing
  - Start with principles of burden sharing
  - But free rider problem, if not all countries join
- Fiscal and supervisory arrangements should move in tandem