

**First meeting of the CEPS Task Force on
Banking crisis resolution procedures**

CEPS, 17 July 2009

Crisis prevention, management and resolution.
Phase 1: Prevention

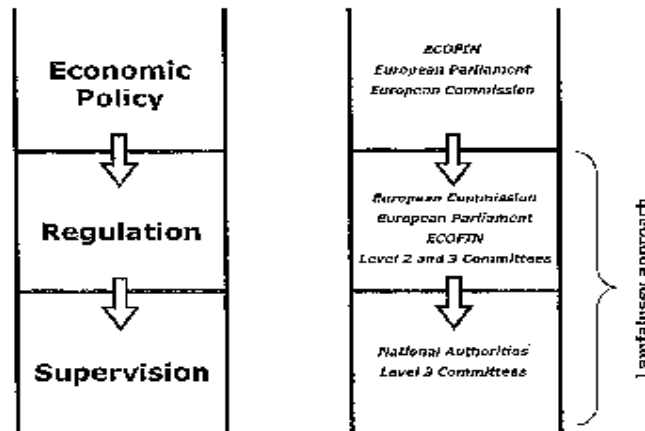
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- Crisis prevention is the first preoccupation of National and EU authorities. This is, first and foremost, a task for microprudential supervision, but also for macroprudential oversight, as indicated in the de Larosière report (Slides 1 & 2)

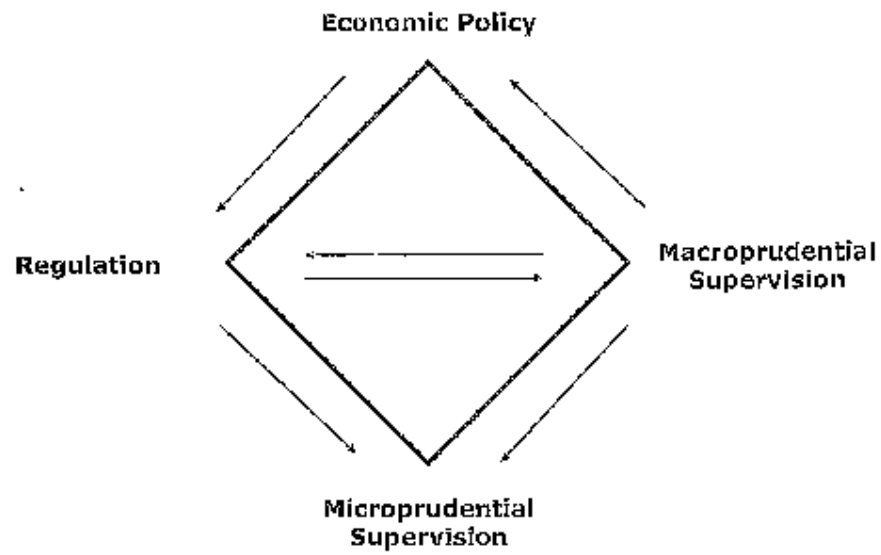
Slide 1

Traditional Ladder Approach



Slide 2

New Diamond (de Larosière) Approach to Prudential Supervision



- Crisis prevention is the realm of supervisory authorities, with central banks placed in a privileged position to detect the first signs of vulnerability of a bank. In countries where supervision is not the responsibility of the central bank, a close, early, collaboration must be ensured between the supervisor and the central bank. The ECB must be brought into the picture at a very early stage, also taking into account its perspective major role in the European Systemic Risk Board.

- A relevant question in respect of crisis prevention is whether current institutional arrangements ensure adequate, prompt interaction between supervision of prudential and conduct of business issues.

A clear viewpoint on this has been expressed by the UK Authorities, with an indication of the need to consider together prudential and conduct-of-business questions. Problems in the mortgage-backed securities market in the US and many other markets demonstrate that conduct-of-business regulation can be as critical for financial stability as prudential regulation. Moreover, conduct-of-business failings within a firm can lead to its own prudential failure. It is therefore essential that national and international arrangements support the necessary collaboration on prudential and conduct issues.

- Microprudential supervision should develop a much closer and positive interaction with risk managers and controllers in the bank/financial firm.

First, the supervisors should satisfy themselves (and should therefore have the intellectual, technical/professional capabilities, and the status/remuneration to do so) that Board Members responsible for risk control and Risk Officers are capable of detecting the early phase of an impending crisis.

The New “Basel” risk/capital approach should pay less attention to mechanical formulas and external credit ratings, and more to an early understanding, also, but not mainly, through models, of critical paths, as indicated below. A fundamental issue of corporate governance must be addressed with a view to aligning incentives for risk takers and risk controllers alike, within and with the firm. One side of the coin is the deferral of payment of performance-related compensation, the other is the introduction of effective checks and balances between risk takers and risk managers, in terms of remuneration, career, status.

- In cross-border banks crisis prevention requires close collaboration, frankness and clear division of responsibilities (notably the definition of common responsibilities) between home and host countries.

The truth of the matter is, instead, that conflicts abound, as evidenced by the very history of the Basel Concordat (1975) in the aftermath of the Herstatt failure, between parent and host authorities, an experience which was repeated in the current crisis. This is one of the main reasons why the de Larosière report made the case for going beyond the system of colleges, and proposed the establishment of authorities, in the framework of a European System of Financial Supervision.

Additionally, inconsistencies between national legislations prevent an orderly and efficient handling of an institution in difficulty. This is especially so when the crisis erupts, but the different arrangements, supervisory standards and institutional frameworks affect also the handling of early stages.

- It must be stressed that the neat separation of the various phases of a banking crisis is more of an academic exercise than a stylized fact.

As the current crisis confirmed, the crisis escalation can be very rapid.

The Basel Accord on capital adequacy, and later the Basel Capital Standard, did not provide a sufficient cushion to dispel doubts on the viability of a banking institution, nor did the existence of the DGSs, whose organisation represented a major weakness in the current crisis and in the EU regulatory framework.

- There is a fundamental need to review in depth the Basel Standard. This is a necessary condition for improved microsupervision and hence crisis prevention. These points are addressed in detail in Maino, Maserà, Mazzoni, (2009) and go well beyond the official proposals for regulatory repair of the capital standard. Radical approaches, which should be carefully studied, have been proposed [Bair (2009), Barone Adesi (2009), Rosengren (2009)], notably:
 - interest-bearing reserve requirements related to idiosyncratic risk of the firm;
 - risk-related insurance fees to account for both idiosyncratic risk and marginal contribution to systemic risk (decided by the microsupervisor);
 - insurance fees covering systemic risk for large, complex financial intermediaries (set by the macrosupervisor in accord with the microsupervisor).

- I confine myself here to crisis prevention, but in concluding my remarks, I stress the fact that there is a logical and operational continuum between crisis prevention and the resolution phase for the negative outcomes: some implications are therefore outlined.

The ultimate responsibility for managing the resolution of banking crisis generally requires fiscal action. When taxpayers' money is at stake, Government/Parliament responsibility is called for. At what stage of the crisis management process the Government (s) must be brought into the picture is a question to be debated. In any event, microprudential supervisory authority needs to be aligned with fiscal responsibility. The home/host division of responsibilities has an obvious bearing on these issues, as was evidenced specifically by the Fortis case. With no EU budget available and in sight, this represents a significant factor limiting the extent to which European national supervisors can devolve responsibility for the supervision of firms to a centralized body. In this respect, we are confronted with a major difference vis-à-vis the US, whose implications must be brought to the fore.

The need for alignment of supervisory and fiscal responsibilities is one of the principal reasons why the de Larosière report – and I personally – considered it inappropriate to entrust microprudential responsibilities to the ECB for large cross-border banks, in spite of some obvious pros.

Admittedly however, the issue of crisis management for large cross-border banks – which were born nationally, prosper as pan-european, but, eventually, become again national in death – is not satisfactorily dealt with at EU level. Hopefully, our group will offer guidelines on this issue. In this respect I found the frankness and openness of certain recent official US contributions on banks “too big to fail” of great interest and worthy of specific attention. [Bair (2009), Rosengren (2009)].