What kind of financial stability for Europe?

By Dirk Schoenmaker

Financial Markets and Institutions Directorate
Ministry of Finance
The Netherlands

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Abstract

Although the debate on financial stability in Europe focuses at what level action should be taken (centralised vs decentralised), the key issue seems what kind of action should be taken to resolve a financial crisis. Two types of arrangements for financial stability (labelled loosely as the market-led and the state-led approach) can be distinguished. Before one argues that ‘some action’ may be needed at centralised level, it should be clear what kind of action should be taken.

In addition to discussing the arrangements to solve a crisis (closure, lifeboat, lender of last resort, government bail-out), we will also look at who is the ultimate provider of funds. An issue for further research is to explore burden-sharing arrangements in the case of a rescue of a cross-border bank whose failure would have a systemic impact in more than one country.

1 This short paper is based on comments as a discussant at a conference organised by the Financial Markets Group at the London School of Economics in July 1999 and is published in: C.A.E. Goodhart (ed.), 'Which Lender of Last Resort for Europe', Central Banking Publications, London, 2000. The views expressed are those of the author and not necessarily those of the Ministry of Finance in the Netherlands.
1. **Introduction**

After the completion of the Single Market, the creation of EMU has given a further impetus to European integration in the area of financial services. This has led some (e.g. Prati and Schinasi, 1999; Bruni and de Boissieu, 1999) to question the arrangements for financial stability in the euro-area. However, the issue of financial stability is not related to the euro-area, but to the European Union as a whole, including London the prime financial market place in the European time-zone.

The key issue in the debate on financial stability in Europe is not who is taking action (centralised vs decentralised) but what kind of action is taken to resolve a financial crisis. I will argue below that one can broadly distinguish two types of arrangements for financial stability (labelled loosely as the market-led and the state-led approach). Before one argues that ‘some action’ may be needed at centralised level, it should be clear what kind of action should be taken. To organise my comments I will use the following framework for financial stability:

1. **Ex ante arrangements:**
   - regulation and supervision;
   - market surveillance.
2. **Arrangements during a crisis:**
   - crisis management;
   - possible use of funds (lifeboat, lender of last resort, government bail-out).
3. **Ex post arrangements:**
   - ultimate provider of funds (commercial, tax-payers).

Although most papers in this volume deal with the first two elements of the financial stability framework, the third element is as important as the first two because the ultimate provider of funds would like to have a say in the crisis prevention and management procedures (Goodhart and Schoenmaker, 1995).

2. **Regulatory and supervisory practices**

An important condition for financial stability is the harmonisation of regulatory and supervisory practices across Europe, as Bruni and de Boissieu (1999) rightly argue. I believe that the process of harmonisation will neither be through regulatory competition (Padoa-Schioppa, 1999) nor through EU-Directives (Bruni and de Boissieu, 1999). The key issue is which supervisory approach will prevail. It might be instructive to draw an analogy with monetary policy. In the run up to the third stage of EMU, the European Monetary Institute (EMI) had to prepare the monetary policy framework. There seemed to be a decisive split on what intermediate targets to use for the monetary policy strategy for EMU: monetary aggregates.
(the German model) or inflation targets (the UK model). The solution to this controversy was to combine the two models in a two-pillar strategy to achieve the objective of price stability (ECB, 1999):

(i) a prominent role for money, as signalled by the announcement of a reference value for the growth of a broad monetary aggregate; and

(ii) a broadly based assessment of the outlook for future price developments.

This compromise was possible, because the two models mainly differed in the emphasis put on various indicators in the information set. Central banks using a monetary aggregate look primarily at money supply figures but also at other indicators, while central banks using an inflation target look at a whole range of indicators including monetary aggregates.

The two main approaches for regulation and supervision can be labelled as market-led and state-led. Supervisors following the first approach allow failures -unless there is a threat of a systemic crisis (e.g. BCCI and Barings)- to reduce moral hazard. Adoption of prompt corrective action -recommended by Bruni and de Boissieu (1999)- or the requirement to keep sub-ordinated debt -suggested by academics such as Kaufman (1992) and Benston (1992)- would fit in this approach. The latter element has been adopted in the recent Basle consultation papers (Basle, 1999). Supervisors following the second approach do not allow failures and rescue ailing banks (e.g. Credit Lyonnais, Banesto, Banco di Napoli).

These two approaches work out quite differently, for example, in the case of consolidation in banking. In the market-led approach, which seems to be followed mostly in Northern Europe, consolidation is achieved by take-overs (friendly and non-friendly). In the state-led approach, which seems to be followed by the Club Med countries, the authorities sometimes play an important role in consolidation (IMF, 1999), if there is any at all. Public ownership of banks is also widespread in these countries. The solution to this dilemma of the market-led versus the state-led approach is not clear. The two approaches are not supplementary as in the earlier example of monetary policy strategy, so a fudge will not work. However, the dilemma needs to be resolved by policy-makers, before one can embark on harmonisation of supervisory rules and procedures in Europe.

### 3. Market surveillance

Another component of ex-ante policy to maintain financial stability is market surveillance. The papers by Aglietta (1999) and Prati and Schinassi (1999) rightly stress this aspect. Although the European financial system is currently primarily bank-based, it is widely expected that there will be a gradual shift to a more market-based system. Market surveillance will therefore become a key element of crisis prevention procedures. After the completion of the Single Market, the creation of EMU has given a further impetus to European integration of financial
markets. Pan-European markets may thus develop, although the current setting is still
dominated by national markets: Europe has about 15 stock exchanges and 25 derivatives
exchanges (IMF, 1999). It is not yet clear what pattern will emerge in Europe: fragmented
markets linked in one way or another, or a few key market places? An example of the latter
can be found in the US, where financial market activities have gravitated towards New York
and, to a lesser extent, Chicago.

The issue at stake is how to organise the process of collecting and interpreting market data.
Aglietta (1999) suggests to establish a European Observatory of Systemic Risk at the ECB:
“a permanent staff should pool information continuously, develop databases, make in-depth
studies on the channels of contagion, on the variation in market liquidity, on the vulnerability
of market intermediaries to abrupt changes in market prices, etc.”. I for one don’t think that
this centralised body will be the first to detect a (potential) systemic problem emerging.
Rather the authorities (supervisors and central banks) in the market places, which are in daily
contact with the key market players and therefore in a far better position to understand and
interpret market data, are likely to be the first to detect potential problems. The LTCM
problem was first detected and then solved by the New York Fed, and not by the central
bodies (the Fed Board or the Comptroller of the Currency). Of course, there were close
contacts between the NY Fed president (McDonough) and the Board (Greenspan) and the
Treasury (Rubin), but the primary place of action -including crisis resolution- was in New York
and not in Washington DC.

So the challenge is to establish reliable and swift communication links from the key market
places in the European Union to the centre in Frankfurt. In this way, market intelligence will
flow from the place of trading to the centre of (monetary) decision-making. An open question
is which European market(s) will become the equivalent of New York and Chicago: London,
or also Frankfurt, Paris, Amsterdam, Milan, …?

4. **Lender of last resort for Europe**

A heated debate is going on about who should act as lender of last resort (LOLR) in the
Eurosystem: the ECB or the NCBs? The papers in this volume (Aglietta, 1999; Prati and
Schinasì, 1999; Bruni and de Boissieu, 1999) argue that the ECB should have the final say
about the possible rescue of an individual bank in difficulties. However, in my view the
national central bank of the home country of the bank in problems should have the final say
and bear the cost of the operation (Schoenmaker, 1995 and 1997). Before discussing the
arguments, it may be useful to note that we all agree on the need for a clear assignment of
responsibilities among the members of the ESCB and a clear communication of this
assignment to the market.
An important distinction in the LOLR discussion is that between a general liquidity crisis and a specific crisis at one or more banks. Only the ECB can formulate a response to a general liquidity crisis. After the establishment of Stage Three of EMU, there is a single monetary policy and a single interest rate. There is no scope for a NCB to relieve monetary conditions in its local market (insofar as local markets continue to exist within the euro-area) during times of crisis without affecting the monetary conditions in the rest of the euro-area. So only the ECB, or more precisely the Governing Council of the ECB, can decide to relax monetary conditions by injecting extra reserves and/or reducing money market rates during times of stress. There is no disagreement about the role of the ECB in a general liquidity crisis.

The debate between the ‘centralised’ and ‘decentralised’ school is about who should act as LOLR in a specific crisis at one or more bank(s). An illiquid bank will, almost always, be able to borrow additional liquid funds to meet a short-term liquidity problem from the interbank market unless the market already suspects its solvency (Goodhart, 1987). A bank which cannot borrow from the money market to meet its liquidity needs is, almost by definition, a bank whose solvency is suspect in that market. A central bank acting as LOLR should therefore be in a position to supervise in order to constrain the use of LOLR and should have the best available information on the solvency of a bank in need of liquidity support. If the central bank is not the supervisor, it will need good and fast communication links with that specialist supervisor, which is usually the case.²

**Decentralised school**

Given the home country regime for banking supervision in the European Union, home central banks are the natural choice to conduct LOLR support, if and when needed (Schoenmaker, 1995). By assigning responsibility to the home NCB, the cost of LOLR support (and deposit insurance payouts, which are also based on the home country principle) will be fully internalised at the home supervisor. Recall that LOLR operations are not without credit risk as the solvency of a bank in need of liquidity support is often suspect. Although a collateral requirement can be imposed, this can not always be enforced in practice. Banks with a sufficient amount of high quality, liquid, paper on their books can usually sell that paper in the market, and hence do not need liquidity support. Consequently, a LOLR has often to secure its loans against lower-grade paper and/or against the loanbook of the ailing banks. NCBs would thus possibly have to accept collateral beyond those assets on the Tier 1 and Tier 2 lists. If the range of permissible collateral were too restrictive, a rescue would not be possible in such cases.

² A good example of such a link is the Memorandum of Understanding (MoU) signed by HM Treasury, the Bank of England and the Financial Services Authority after the banking supervisory and monetary policy functions were separated in the UK. This MoU specifies the role of each of the parties during a crisis, including that of possibly providing emergency liquidity assistance to troubled banks by the Bank and that of providing information on these banks by the FSA.
The legal base for the NCB’s role as LOLR in the Eurosystem can be found in Article 14.4 of the Statute of the ECB (Council of European Communities, 1992): “National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions should be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.” (italics added by author)

The choice for a decentralised LOLR is based on the argument that the supervisory and lender of last resort functions are intrinsically linked during times of crisis. The supervisor has first-hand information on troubled banks and has the authority to withdraw their licence (in which case the deposit insurance agency will have to pay-out on insured deposits). The central bank has -in consultation with the government- the authority to extend liquidity support to keep troubled banks afloat. Faced with a bank in difficulties, the authorities have basically four alternatives: to close the bank in problems, to facilitate a merger with a healthy bank, to provide emergency liquidity assistance or to provide a capital injection. Faced with a bank in difficulties, the authorities have basically four alternatives: to close the bank in problems, to facilitate a merger with a healthy bank, to provide emergency liquidity assistance or to provide a capital injection. To make the decision-making incentive compatible (i.e. choice for lowest cost alternative via internalising the cost of all alternatives), the cost should be borne at the same level of decision-making (centralised or decentralised).3

Centralised school

The case of the centralised school rests on three arguments: i) LOLR operations have close implications for monetary policy; ii) national authorities could be ineffective supervisors or practise forbearance; iii) systemic risk should be judged at an EMU-wide level.

Starting with the first argument, Aglietta (1999) argues that decentralising LOLR operations to NCBs is utterly inappropriate, because of the close implications for monetary policy. However, the monetary effects of LOLR operations can be undone by open market operations on the same day or the next morning. NCBs should therefore be required to inform the ECB about LOLR operations, so that the ECB can arrange offsetting transactions. But there is no need for approval by the ECB.

Turning to the second argument, Bruni and de Boissieu (1999) argue that the central level could criticise national authorities for being too lax (both in supervision and providing LOLR support). NCBs may be overzealous in assisting their local banking system, even if there is no direct systemic threat. To avoid moral hazard, it is advisable to reserve LOLR support only

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3 Prati and Schinasi (1999) suggest that the cost of centralised LOLR intervention could be borne at the national level, because it is on the basis of information provided by national authorities that centralised LOLR intervention would be based. However, decision-making would no longer be incentive compatible. The principle of “he who pays the piper calls the tune” would be violated (see also section 5).
for genuine banking crises that have the potential to create a systemic crisis. Although I sympatise with the objective of Bruni and de Boissieu -constraining the use of LOLR-, I do not agree with the proposed way of achieving that objective -assigning the LOLR decision to the ECB- for several reasons. The first is that generous LOLR support is only one element of a lax supervisory stance. Other elements are, for example, forebearance and weak supervision. Assigning the LOLR decision to the ECB would only be a partial solution. The real problem is the supervisory approach chosen by a country and should therefore be tackled on the political level (see section 2 on the wider debate on harmonising supervisory practices). Another reason is that by forcing the ECB to take the LOLR decision in individual cases, it may become unnecessarily politicised.

The third argument, however, has some merit and may turn the balance in favour of the centralised school in the future. I don’t share the explanation by Aglietta (1999) that “the EMU area-wide externalities inherent to systemic risk in a single monetary area can only be internalised by a systemic regulator which is the ESCB as a whole.” The impact of systemic risk is not necessarily linked to the geographic domain of the monetary authority. The impact of a failure of a small German savings bank, for example, is likely to be confined to the Land in which it is incorporated, while the failure of Deutsche Bank may have systemic ramifications throughout Germany, as well as in London (a large part of Deutsche’s wholesale operations is done from the London office) and New York (after the take-over of Bankers Trust).

The key question is what is the appropriate level to make an adequate assessment of the systemic implications of a crisis, as Prati and Schinasi (1999) correctly argue. In the European context, this could be at the level of the nations, the euro-area or the European Union. As long as the cross-border spill-overs of bank failures in Europe are limited, the home country approach for banking supervision, deposit insurance and LOLR would suffice. When pan-European banks emerge -posing a systemic risk across Europe-, the case for a centralised LOLR strengthens. In that case not only the LOLR, but also supervision and deposit insurance should be in some way centralised.

**Implications for supervision**

National supervisors (and central banks as LOLR) could then work in different modes as suggested by Padoa-Schioppa (1999). In the stand-alone mode national supervisors would operate in the national context. In the bilateral mode two national supervisors would co-operate. In the multilateral mode a group of national supervisors would work collectively as a single consolidated supervisor, the “euro-area supervisor” (Padoa-Schioppa, 1999). This would be needed when the potential systemic problems are European-wide. There is, of course, no need to confine the multilateral mode to the euro-area. Given the position of London as prime financial market place in Europe, it would be wise to include the national
supervisors of all EU Member States in such a European entity. Padoa-Schioppa (1999) observes correctly that the need to develop the multilateral mode has been limited so far, as the emergence of the Single Market in Banking has been slow, but in the future the multilateral mode may have to deepen substantially.

Given the emergence of financial conglomerates in Europe (as well as in the US with the pending abolition of the Glass-Steagall Act), the bi- and multilateral modes of co-operation will need to include not only banking supervisors, but also securities and insurance supervisors in order to deal effectively with (troubled) pan-European financial conglomerates.

5. Ultimate provider of funds

As already indicated in the introduction, there are three possible source of funds to rescue troubled banks: a lifeboat (financed by commercial banks), LOLR support and a government bail-out. The lifeboat approach depends on the cohesion of a well-defined group of banks who are prepared to finance a self-supporting regime. International competition, deregulation and the growing fuzziness of the dividing lines between banks and non-banks have to a large extent diminished the prospects for the use of a lifeboat (Goodhart and Schoenmaker, 1995). In the European context, the solidarity among banks to contribute to a rescue-operation is likely to decline even further (see also Prati and Schinasi, 1999, on this aspect). This leaves us with LOLR and government support as potential sources of funding.

While a central bank can extend emergency loans for unlimited amounts, its capacity to absorb losses is limited (up to the size of its capital). The deep pockets do therefore not lie with the central bank as sometimes is suggested, but with the government. Moreover, any losses absorbed by the central bank will result in a lower pay-out (on seigniorage) to the government and thus ultimately be borne by the tax-payer.

As Charles Goodhart and I argue in an earlier paper “he who pays the piper calls the tune” (Goodhart and Schoenmaker, 1995, p. 555). In a cross-country survey of bank failures, we observe a trend towards using tax-payers’ money. If the tax-payer is seen as potentially liable, then the government has the ultimate responsibility, so that the regulatory and supervisory agency should answer to it.

Whether the central bank or the government is providing the funds, further research is needed on how to share the cost among countries in the case of a rescue of a cross-border bank whose failure would have a systemic impact in more than one country. This research would focus on the design of a mechanism to link (e.g. on a pro-rata basis) the potential systemic impact with its associated cost to the contribution in the potential cost of the rescue operation.
References


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