Interview: Peter Praet

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Abstract: In an interview, Peter Praet, executive director of the National Bank of Belgium, talked about how an existing European institution could be refocused to help save cross-border European banks. According to Praet, any reform has to be holistic. You need to have good regulation, good supervision and good crisis management. You need to develop a framework that allows for all three. Ultimately, Europeans should have the vision to create a resolution authority. A true European authority for financial crisis resolution of large cross-border banks. There are many bits and pieces that can be put in place to progress towards a resolution authority. Europeans have the memoranda of understanding on the principles of crisis management. They can also set up an FDIC-like institution that gets involved early, that has a big budget and that can restructure and then sell off failed banks. An independent observer in the event a crisis hits a cross-border bank could also be very useful.

Full text: Fortis's collapse all too well illustrated the difficulties in saving cross-border European banks. But the ideal solution, a European crisis resolution authority, remains a distant dream. However, an existing European institution could be refocused to do much to help, Peter Praet tells Claire Jones.

You said last year that not enough had been done on cross-border crisis resolution. Where are we now?

We know that any reform has to be holistic. You need to have good regulation, good supervision and good crisis management. You need to develop a framework that allows for all three. Ultimately, we should have the vision to create a resolution authority. A true European authority for financial crisis resolution of large cross-border banks. Most would say this is unrealistic. But, when we look at the history of Europe, many things have been seen as too visionary. And if we don't have that ambition then the financial system is going to be a lot more fragmented.

So without this you'll have the same problem as before the crisis, where individual states act in their own interest when cross-border banks fail?

Individual countries will push for standalone subsidiaries. Systemically important institutions will in some way be curbed. Under the European framework, banks have the right to set up branches. But, in practice, many cross-border banks tend to manage their branches and subsidiaries in a very centralised way, where a number of functions are managed from the headquarters. In supervision, if we don't move further towards a European system, then we have no other choice than to have more standalone subsidiaries.

We are already looking at things more at the national level, like liquidity for example [the UK FSA has recently introduced its own liquidity guidelines].

But what about using these legal structures, such as standalone subsidiaries, as a means to control cross-border failure?

That's only a short-term fix. A resolution authority is needed for a more long-term solution.

There are many bits and pieces that can be put in place to progress towards a resolution authority. And we're not going to have a big bang so these need to be considered. We're putting in place a number of pieces in this puzzle. But before you start, you need to know how the jigsaw will look like once the last piece is in place.

So what are the other pieces?

We have MoUs [memoranda of understanding] on the principles of crisis management. When it comes to a

crisis, MoUs are often not well respected and almost always mean "me over you". But, still they are important because these are commitments that countries sign up for.
You can also set up an FDIC-like institution that gets involved early, that has a big budget and that can restructure and then sell off failed banks. In the US the anti-trust authorities don't have to intervene in the banking sector. It's a very coherent scheme although it doesn't cover all institutions. In Europe, the costs of bank failures are likely to be much greater when authorities do not have the tools to intervene and act in an uncoordinated way.
We are looking at ways to ensure each country has the same tools of intervention when a crisis hits a bank. This is not the case today. In the Fortis case, for example, Belgium and the Netherlands had different tools.
There is a relatively large consensus that you need to find funding from the banks. If there's another shock, it is unlikely that government money will be available. It's time to have an ex ante fund so that the money's there when the crisis comes. It would have broader objectives than only deposit protection, however. We must have this vision and we have to start now.
Another instrument is the so-called "living will" or recovery plan of banks. Each cross-border bank would need to put together a recovery and resolution plan. The recovery part concerns the bank itself. Its own living will. And then you have the resolution, which is what we talked about here. The Financial Stability Board just started working on recovery plans under Paul Tucker [the deputy governor for financial stability at the Bank of England]. It will be very interesting to see how living wills are developed and how authorities accept them. The territorial aspect will be a key issue as living wills can be designed along business lines across borders, or alternatively for each standalone subsidiary so as to make it easier for authorities to intervene and to sell banks in the event of a crisis.
An independent observer in the event a crisis hits a cross-border bank could also be very useful. You have to see how a negotiation happens to understand why this can be so effective, why a non partisan facilitator can influence the dynamics of crisis negotiation. It does because you have a third party, only looking at the common good.
You put all these pieces together and then you say, well why not a European resolution authority?
Is there anything else?
Yes, one of the crucial things is how an institution is unwound, how it is being restructured after state aid. And when you think about it the European Union's Directorate General for Competition has in fact some of the characteristics of a resolution authority.
This is a bit of a revolutionary idea, I admit. And, of course, national governments intervene first. But when a government injects money into a bank it falls under the EU's state aid rules, and very quickly the DG Competition says: "We understand there's a financial stability problem, but we need to assess the consequences of that aid on the banking industry." And when the state intervenes it has to submit the restructuring plan and they will assess the plan according to its criteria. Banks might have to sell assets, reduce market share, things like that.
These principles are usually those that you have with a resolution authority. And the beauty of it is that these are already applicable across Europe. There is already a lot of power at the European level: although the European Commission does not intervene in the rescue phase, it has an important role in the restructuring phase. This will undoubtedly influence national resolution authorities' behaviour when they decide to intervene in a bank.
Is work being done on this?
Yes. DG Competition is now putting down some principles for assessing what happened during the crisis. So you are starting to get a framework, which looks more harmonised than it was before. It's not perfect because DG Competition was neither mandated nor prepared to deal with banking crises.
A key reason why DG Competition has a clear role in the whole resolution process is that, contrary to aid for

industrial firms, state aid in a systemic bank creates a positive externality for its competitors due to banks' interlinkages. As a result, state aid approval is a very difficult balancing act. That sort of question makes state aid in banking of a different nature than many other sectors.

Two points. If you've got a pan-European resolution authority and it's funded by the banks, then doesn't that implicitly imply that you need panEuropean regulation as regulation must be equally stringent across the EU in order to avoid arbitrages? Second, with the DG Competition is it not best to have the cards on the table rather than use the institution for a purpose other than for which it was created?

On the first, yes I understand and agree. On the second, that's my point. They do things they were not designed to deal with already. But their remit, in some ways, is a very good fit. And you can broaden the criteria of assessment for state aid to include other things which incorporate the externalities that relate to the resolution of banks, which are both issues of competition and financial stability.

I'm not saying everything is going to succeed, but at least a role for DG Competition has to be part of the reflection on a European resolution authority.

When the crisis hit in the autumn of 2008 there was virtually no preparation on what could be expected to come as state aid. After a number of banking accidents, a disaster looked likely so you had heads of state gather in Paris in October to agree on a number of commitments and conditions on interventions. Just afterwards, the European Commission gave guidance to member states on measures related to the banking crisis, after which the European Central Bank issued recommendations on state guarantees. In other industries, only DG Competition would have been involved in determining conditions for state aid.

If they were to take on this new role, they would need the rules ex ante and the staff to deal with it. We don't have that now obviously. But this is one of the only true European institutions that we now have that could play a credible role in resolving failed banks.

This deals with very touchy, politically sensitive things. But DG Competition does these things anyway. We just need it to do them in a more systematic way. If you can clarify how DG Competition does it, then it influences the whole resolution process ex-ante.

When Fortis failed, Jean-Claude Trichet came to Belgium to say that the way that you're going to manage this crisis would have consequences for the rest of Europe. It would influence market psychology. There are externalities depending on whether you manage it well or badly. Some authority has to tell you to behave correctly and solve the problem.

Couldn't problems arise with Molls that are similar to problems with sovereign risk in Europe? In the stability and growth pact you've got a pretty clear set of guidelines that have been, well, flouted really. And there was no consequence ofthat in the good times.

It's a good question. We have to look at what the parallel is in banking: in banking you have DG Competition, which already has a lot of power. The balance sheet of assisted banks often had to shrink by 30-40%. This is indeed sizable. So, sanctions exist already under the state aid rules. You don't have such an organisation imposing conditions on a sovereign state.

If we have a resolution fund, then some could still argue that this creates moral hazard. But that depends on the credibility of the resolution process. If the national authority steps in to save a bank but a resolution authority is expected to impose a severe restructuring and a place a burden on shareholders and other creditors, then that's a big disincentive to get in trouble.

The cultural environment at DG Competition is one of being tough. The resolution process begins at a national level but it ends here.

It sounds an effective way of dealing with the moral hazard problem. But is there not a danger that you're creating a purpose for an institution for which it was not originally intended?

That's what you have to really find out and clarify. Even if there is no big political will, the institution is there. Many countries are not very satisfied about the way DG Competition intervened. We need to look at this in detail, but the essence is still how the credible threat of DG Competition can influence the national resolution process. For example, the commission could integrate in its state aid assessments criteria for the degree to which national resolution authorities acted in a cooperative way to minimise the total costs of crisis resolution, including moral hazard. A European resolution authority like the FDIC will be difficult to put in place, but the resolution mechanism can be significantly be improved through DG Competition.

Sidebar

Peter Praet was appointed executive director of the National Bank of Belgium in 2000 and is responsible for international cooperation and financial stability. In 2002 he was also appointed to the Management Committee of the Belgian Banking, Finance, and Insurance Commission (CBFA), where he is responsible for prudential policy for banking and insurance.

Before joining the National Bank, Praet served as chief of cabinet for the Belgian Minister of Finance from 1999-2000, as chief economist of Generale de Banque and Fortis Bank from 1988-99, as professor of economics at the Université Libre de Bruxelles from 1980-87, and as economist at the International Monetary Fund from 197880. Praet earned a doctorate in economics from the Université Libre de Bruxelles in 1980. He teaches money and banking at the Université Libre de Bruxelles, and from 2001-2004 he held the Chair of Business Ethics at the Faculte polytechnique and the Solvay Business School of the Université Libre de Bruxelles.

Praet serves on several high-level international committees, including the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System, the Committee of European Banking Supervisors, and the Banking Supervision Committee of the ESCB as Chair. He is an alternate director of the Committee of GIO Governors and the International Monetary and Financial Committee. He is also co-chair of the Research Task Force of the Basel Committee on Banking Supervision.

Praet is a member of the board of the European think tank Bruegel (Brussels European Global Economic Laboratory).

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