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Cross-border resolution of failed banks in the EU: A search for the second-best policies

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Abstract

This paper analyzes the reasons for the failure of the multilateral resolution of EU cross-border banks such as Fortis. We argue that the pre-crisis regime based on soft law and voluntary coordination was unable to align the incentives of national authorities acting under the time pressure and uncertainty of a banking crisis. We ask whether this experience induced the Commission to propose reforms that would close the regulatory gap between integrated cross-border banks and national resolution regimes. Although, the Commission proposals submitted within a year of the crisis considered the more radical reform options, such as shifting the regime to the EU level or reorganizing cross-border banks so that they could be resolved on the national level, in the end the Commission supported the traditional reform path of deepening soft law and strengthening pre-crisis governance arrangements. At the same time, the new financing mechanisms introduced to stabilize the Eurozone can pave the way for the introduction of an EU-level bank resolution regime, when the next reform opportunity arises.

Keywords: banks, resolution, European Union, reform, financial crisis

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INTRODUCTION

The financial crisis tested the viability of the EU's single banking market and its underlying regulatory framework under severe market conditions. It has highlighted the gap between the degree of financial integration manifested by the presence of large cross-border banks, on one hand, and limited regulatory integration exemplified by the country-based bank resolution regimes, on the other. This paper analyzes the EU experience with the resolution of failing cross-border banks and reviews the search for reform options during the first year after the crisis.

Exogenous shocks such as financial crises tend to open policy windows for reforms that would be implausible during periods of stability (Kingdon 2003, Rodrik 1996, Drazen and Grilli 1993). The 'benefit of crisis' argument emphasizes the fact that the crisis experience forces important stakeholders to reconsider their policy positions, thus opening space for policy entrepreneurs who are ready to explore new opportunities. Within the EU decision-making process, it is the Commission – with its monopoly on legislative initiative – that must decide whether the crisis created a policy window for path breaking reforms.

This paper asks whether the crisis experience induced the Commission to propose a more radical reform of the EU bank resolution regime that goes beyond the pre-crisis status quo. To answer this question, we first review the crisis experience. Building on the game-theoretic analysis we show that national authorities face conflicting incentives stemming from their exclusively national mandates to protect financial stability at no or the lowest possible cost to domestic taxpayers. We apply the concept of a globalization trilemma to the problem of the cross-border bank resolution and argue that there are two first-best solutions capable of containing the conflicts among national authorities. The resolution regime can either be shifted to the EU-level, which provides the largest possible jurisdiction matching the operations of large European banking groups, or it could be shifted back to the national level, which would require the cross-border banks to reorganize as a string of independent national subsidiaries.

In the second part, we review the Commission's Communication on cross-border crisis management in the context of the existing academic and policy literature in order to ascertain whether the crisis indeed created a policy window and whether the Commission tried to seize it by supporting more radical reform options.[1] We show that the first-best reform options were seriously considered. This is a marked change from the pre-crisis debate, which confined such options only to academic literature. However, in its impact assessment of the proposed reforms (Commission 2009), the Commission decided to rally behind the strengthening and deepening of the pre-crisis policies. As the policy debate nears the final decision, the first-best options have been sidelined and the traditional EU approach has regained prominence. Unless the ongoing aftershocks of the financial crisis – such as the Eurozone response to the Greek problems of 2010 – open new policy windows on fiscal burden sharing, the post-crisis EU bank resolution regime will be merely an upgraded version of the pre-crisis one. Although such a regime constitutes an improvement, it preserves the conflicting incentives of national authorities that derail cooperative cross-border resolutions during crises. Such a regime lacks the capacity of the first-best solution to either prevent or internalize the positive and negative externalities of cross-border bank integration.

The paper provides answers to two simple questions: why did the Dutch and Belgians failed to resolve Fortis on multilateral bases despite the long tradition of cooperation and why is the EU not introducing reforms that could prevent such failures in future. The simple answer to both questions is the conflict of interests among key stakeholders. In the first case, uncertainty over the distribution of fiscal burdens undermines cross-border cooperation among national authorities, unless there are some binding commitments to cooperation and burden sharing. In the second case, the progress towards the EU level regime is blocked by member states' concerns about infringements on fiscal sovereignty, whereas re-embedding of cross-border bank subsidiaries in national regulatory regimes is inhibited by the Commission's and banks' concerns over regulatory protectionism. The paper concludes that although the crisis created political momentum for reform, it did not align the interests of the key stakeholders behind any of the two first-best reform alternatives.

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[1] The analysis is based on the Commission Communication on European Financial Supervision (COM(2009) 252 final) and the subsequent inter-institutional negotiations leading to the adoption of the new architecture by the Council and the EP in September 2010, as well as the Communication on An EU Framework for Cross-Border Crisis Management in the Banking Sector (COM(2009) 561 final) and the related impact assessments.

1. INTEGRATED BANKS AND THE NATIONAL RESOLUTION REGIME

During the pre-crisis decade, the EU had witnessed an unprecedented wave of cross-border mergers of large banks fueled by the internal dynamics of financial markets and the introduction of the euro (Dermine 2000, Veron 2007). At the onset of the financial crisis, there were 39 cross-border banks and around 100 other banking groups that had large subsidiaries or systemic branches in another member state (Commission 2009). Although they represent a small percentage of the total 8,300 EU banks, they are the most important as they control approximately 68% of total EU banking assets.

Many observers argued for an introduction of a resolution regime capable of handling cross-border failures of large banks (Dermine 2000, Vives 2001, Schoenmaker 2009, but the attention of policy-makers was focused on the prevention of banking failures. The EU regulation and supervision regimes were updated through the Capital Requirement Directive, but the resolution regime received much less attention.

The resolution regime forms the third line of defense against financial instability. It is invoked when regulation and supervision fail to prevent the fatal moment when authorities must decide whether to let a bank fail or intervene to keep it as a going concern, even if it requires putting fiscal resources at risk.[2] Neither of the two options is appealing, especially in the case of systemically important banks. Bank failure and liquidation induces the immediate risk of financial panic throughout the system. Bank bailouts then translate into increased responsibility for operation of the financial system and accumulation of fiscal liabilities.

An important goal of the bank resolution regime is to minimize the fiscal costs of banking crises. Although, there are rare cases when governments allow a large bank to fail or when a bank resolution is financed solely by the private sector, it is an empirically supported fact that governments tend to intervene and spend considerable resources in dealing with the consequences of banking crises. The EU experience during the 2007-2009 financial crisis

[2] The bank resolution regime is a set of legal and administrative rules that authorities employ to support restructuring of an ailing bank, in order to maintain financial stability and ensure continuity of basic banking services. Certain functions of large banks such as credit provision, processing of payments and monetary transmission have the public good character and need to be preserved even if the bank becomes insolvent and should be wound up. The bank resolution regime, unlike corporate bankruptcy, recognizes these functions and provides tools to preserve them.

conforms to this pattern. Nineteen EU governments introduced guarantees and recapitalizations, thus putting at risk fiscal resources equivalent to 32% of EU-wide GDP, out of which approximately a third was used by banks by mid 2010 (Commission 2010a). Such figures are consistent with the worldwide crisis experience over the last three decades, during which the estimated direct fiscal costs of a banking crisis were about 13% of GDP (Laeven and Valencia 2008).

A novel aspect of public interventions in this crisis is their cross-border dimension. It is no longer sufficient to intervene on the national level, when an ailing bank is systemically important in several countries. The integration of banks introduced a new interdependency between governments, as the decision whether and how to intervene is related to the same choices of other governments. Unless any single government is willing to subsidize the resolution of a cross-border bank, they must cooperate and share the fiscal burden of the resolution.

As in other interdependent situations, there is a scope for strategic behavior. The choice situation resembles the prisoner's dilemma, when the cooperative solution is likely to be the least costly overall, but national authorities have an incentive to defect to a non-cooperative solution, if they believe that unilateral action would reduce their costs below their share in the cooperative solution. Two important characteristics further complicate cross-border resolution: firstly, banking crises tend to unfold with incredible speed and, secondly, the amount of fiscal resources required tends to be not only high, but also highly uncertain. Nevertheless, cooperation in the prisoner's dilemma game should still be achievable, if the authorities involved can communicate effectively and make *ex ante* commitments enforceable by an independent third-party (Scharpf 1997). EU jurisdiction makes both of these conditions possible, providing that such communication and coordination rules are enshrined in EU legislation.

Time pressure, high stakes and high uncertainty make calculated decisions in the heat of a banking crisis difficult. Without effective and binding rules, the authorities may misjudge the situation and defect to a unilateral option. They often have lass than 60 hours, between the time banks closes on Friday and reopen Monday, to agree on a resolution scenario, which may simply be impossible. Similarly, if one government believes that it can manage the resolution better than its partners in other EU countries, or if it believes that part of a cross-border bank within its jurisdiction controls assets of better quality than parts in other EU countries, then it may opt for uncooperative unilateral action. To reduce the effects of time pressure and high uncertainty on the choice between cooperation and defection, *ex ante* rules are required that guarantee effective communication, guide the search for cooperative action and ensures acceptable sharing of fiscal burdens. The pre-crisis regime tried to provide such rules through soft law arrangements and voluntary cooperation among authorities.

2. THE PRE-CRISIS RESOLUTION REGIME

The pre-crisis resolution regime was not embedded in EU legislation. The Capital Requirement Directive stipulated only one resolution-related requirement: alerting the central banks and ministries of relevant member states about an emergency situation in a cross-border bank. Similarly, the directives on the Deposit Guarantee Schemes and the Reorganization and Winding-up of Credit Institutions defined some guiding rules for cross-border bankruptcy, but not for the resolution of a bank in crisis.

The Memorandum of Understanding (MoU) on high-level principles of cooperation between banking supervisors and central banks of the EU in crisis management was the first policy response to the eventuality of a cross-border bank resolution (ECB 2003). It was signed in March 2003 and defined the elementary principles of cross-border cooperation. It identified authorities responsible for crisis management and, specified the required flows of information and logistical infrastructure. It also dealt with stages of detection and the activation of specific supervisory and central banking tools in financial crises (ECB 2005). The next MoU, adopted in May 2005, expanded the information exchange to include the sharing of prospective assessments among authorities potentially involved in a crisis situation. It attempted to address problems in sharing confidential information and called for the development of contingency plans, on the national and EU level. At the same time, the information released about the MoU explicitly states that it is legally non-binding and contains no *ex ante* burden-sharing arrangement between national treasuries (ECB 2005).

The 2003 and 2005 Memoranda were tested in a simulation exercise at the ECB in which banking supervisors, central banks and finance ministries from the then 25 EU countries participated. It revealed the inadequacy of the framework; cooperation was not sustained even under simulated crisis conditions (Pisani-Ferry and Sapir 2009). The ECOFIN Council responded by setting up a special working group charged with suggesting new arrangements for crisis management. Nevertheless, at the onset of the financial crisis in August 2007, the two MoUs were all that were in place for the EU bank resolution framework.

The third generation MoU was signed only in June 2008. It was a multilateral agreement signed by all 114 member state authorities whose cooperation might be needed in the case of a resolution of a bank present in all 27 countries. Unlike previous MoUs, this was made public to bolster the preparedness of the EU to resolve a potential cross-border banking crisis. It deepened cooperation procedures by making them increasingly specific. It continued the trend towards developing specific arrangements tailored to the most important cross-border banks. The Memorandum called on relevant authorities to develop "voluntary specific cooperation agreements" and specify the "cross-border stability groups" charged with the crisis management and resolution of cross-border financial groups.

The MoUs were indirectly supported by the new governance mechanisms that have emerged in the EU financial market policy over the last decade. The most notable were the Lamfalussy committees that were delegated some rule-making and monitoring powers as part of comitology reforms designed specifically for financial regulation (Quaglia 2008, Christiansen and Vaccari 2006). The Committee of European Banking Supervisors (CEBS) not only improved the consultation, decision-making and monitoring processes in EU banking regulation, but also provided a permanent cooperation platform for all member state regulators. Although, CEBS was not designed to deal with cross-border resolutions, it proved useful in handling the cross-border fall-out resulting from the Icelandic crisis (EFC 2009).

The colleges of supervisors represent an additional governance mechanism that began to emerge before the onset of crisis. The requirements for consolidated accounting on the group level and the need for supervisory approval of the risk models under the Basel II rules have strengthened the role of home supervisors. They increasingly played a coordinating role within the group of host-country supervisors of the 40 or so largest EU cross-border banking groups. The increasing formalization of the colleges put them in a position to act as the "cross-border stability groups" called for by the 2008 MoU, and prepare the "voluntary specific cooperation agreements" that were supposed to include *ex ante* fiscal burden sharing rules.

Overall, the pre-crisis cross-border resolution regime amounted to little more than soft law declarations supported by emerging committee-based governance mechanisms. The MoUs specified basic coordination rules, but left the burden sharing rules up to the colleges. These arrangements were explicitly voluntary and non-binding and thus unable to close the gap between cross-country banks and country-based resolution regimes, as demonstrated in the case of the Fortis resolution.

3. THE FORTIS EXPERIENCE

The Fortis resolution provided the most direct test of the EU cross-border bank resolution regime. The bank had a systemic presence in all three Benelux countries, which have a strong tradition of policy coordination. Moreover, it was one of the banking groups with the most developed *ex ante* cooperation arrangements among its supervisors that dated back to 2002 (Van den Spiegel 2008). Nevertheless, when these arrangements were tested by the crisis, they failed to sustain a fully cooperative multilateral resolution.

Fortis was created by a merger of several Dutch and Belgian banks and insurance companies in 1990. It expanded rapidly throughout the EU and later globally; in 2007 it acquired ABN AMRO in the largest-ever banking takeover. Fortis became one of the largest EU financial institutions, and its balance sheet exceeded the GDP of all three Benelux countries. Fortis Group had its headquarters in Brussels, and the Belgian financial authority was its home-country supervisor.

Following the turbulences in global financial markets, Fortis Bank – the entity controlling the three Fortis banks in the Benelux countries and the retail operations ABN AMRO – experienced difficulties in financing the 2007 acquisition. This led to a dramatic fall in its share price and the replacement of several key banking officers. The situation escalated on Friday, 26 September, when bankruptcy rumors led institutional clients to withdraw €20bn in deposits (Fortis 2008, Commission 2009). The expectation was that a further €30 bn would be withdrawn when the bank opened on Monday. At the time, Fortis no longer had access to the interbank market and was relying on an emergency liquidity scheme provided by the central banks of Belgium and the Netherlands. Although Fortis was technically solvent at a time (Cihak and Nier 2009:23), something had to be done to stop the run on the banks' deposits.

The Benelux governments approached Fortis with an offer of assistance and negotiated a capital increase of €11.2 bn that would partially nationalize Fortis banks. The Netherlands and Luxembourg would invest €4 bn and €2.5 bn in exchange for 49% of shares in Fortis Bank Nederland and Fortis Banque Luxembourg, respectively. The Belgian government was to invest €4.7 bn in exchange for 49% of Fortis Bank, which controlled all three Fortis banks in the Benelux countries. The Dutch government, however, later withdrew from this plan.

Even before it turned out that the plan would not be implemented, it became clear that it would be inadequate. The run on Fortis banks continued and they had drawn nearly €60 bn of the emergency liquidity (Fortis 2008). On 2 October 2008, the Dutch authorities announced their intention to impose forced administration on the banking and insurance activities of Fortis in the Netherlands.[3] This gave the Belgian authorities and Fortis directors little room to negotiate, thus they agreed to sell the Dutch parts of Fortis after negotiating a price increase from the initial €9 bn to the final €16.8 bn. Luxembourg increased its share in Fortis Banque to 52%, and Belgium acquired the remaining domestic and international banking and insurance activities of Fortis (Cihak and Nier 2009). The government takeovers stabilized Fortis and the attention shifted towards consolidation and sale of the acquired assets. This phase of the resolution was conducted on the national level and is thus not relevant for the discussion of cross-border issues.

Prior to the critical week, the Benelux authorities had three options for organizing financial assistance. The first was to rely only on Belgium, the home country of Fortis; the second was a coordinated multilateral bailout; and the third was a unilateral bailout of the Fortis parts in each country. The first option was used in the case of other banks such as ING in the Netherlands and KBC in Belgium, but since Fortis had systemic presence in all three countries it would result in a massive cross-border subsidy. The governments of the Netherlands and Luxembourg recognized this and offered their support to the rescue plans.

The second option – multilateral action – was the one expected by the MoUs, which called for "voluntary specific cooperation agreements" to deal with such situations. The third option – unilateral action – would correspond to the pre-single market approach, when a cross-border bank would be split along national borders and respective national authorities would resolve each part. The choice between the second and third options can be modeled as a prisoner's dilemma game (Figure 1). The multilateral resolution would correspond to a multilateral outcome (M, M in Figure 1), whereas the unilateral resolution corresponds to the unilateral outcome (U,U).

[3] Given that the Fortis bank, ABN AMBRO and Fortis insurance firms were all organized as nationally incorporated subsidiaries – not branches – the EU legislation provided the Dutch authorities with full right to impose forced administration according to national laws.

Figure 1: The prisoner's dilemma in cross-border bank resolutions

		Netherlands	
		Multilateral (M)	Unilateral (U)
Belgium	Multilateral (M)	3, 3	1, 4
	Unilateral (U)	4, 1	2, 2*

Note: * Nash equilibrium. The higher the number in cell, the more preferred the outcome for given player. Preferences are expressed in terms of ranking of pay-offs; the highest payoff (4) is the most preferred solution of a given actor. As our purpose is to demonstrate the conflicting incentives, we simplify the presentation of the Fortis case by focusing on the interaction between the Belgian and Dutch authorities. The Luxembourg government seemed willing to adapt to outcomes of their negotiations.

Given that all three governments were prepared to offer support to Fortis, multilateral action seemed to be the most likely option. Yet, the final resolution was unilateral. The answer to this puzzling outcome lies primarily in the absence of EU-level rules on banking resolutions that would credibly align the conflicting incentives of national authorities.

The 2008 MoU was signed only three months before the Fortis crisis, thus the envisaged agreements for the cross-border resolution were not yet fully in place. However, the Benelux banking authorities have a long track record of policy cooperation, so they should have been able to agree on an *ad hoc* solution. Indeed, the first intervention agreed on 28 September 2008 was planned as a multilateral action, until the Dutch authorities chose not to carry it through.

Multilateral action would, in principle, be in the best interest of the intervening governments because it preserves the benefits of internal integration of cross-border banks and avoids the costs of breaking them up along national borders.[4] Cross-border banks such as Fortis gained considerable efficiencies from integrating their internal functions across national boundaries. Increasingly, strategic decision-making, capital management and allocation, risk management and auditing were concentrated at the headquarters of cross-border financial groups, while other functions – such as back-office, information technologies, liquidity management, asset and liabilities management or human resources

[4] The Fortis directors believed that multilateral resolution would be more efficient (Fortis, 2008), which is a view shared by some independent observers as well (Cihak and Nier, 2009)

management – were similarly concentrated on the group level, although not necessarily in the home country (van den Siegel 2008). Multilateral action should preserve this arrangement and avoid a chaotic break up of subsidiaries that are not operationally independent.[5]

However, a multilateral resolution inevitably pools not only the fiscal risk of intervention across participating countries, but also gives them a stake in later sales of assets that may offset the cost of intervention. Pooling these risks and benefits limits the extent of good and bad surprises, when governments opting for unilateral action discover that their part of the cross-border bank is in much better or worse shape than expected. However, the governments that believe the parts of the cross-border group in their territory are in much better shape than the others would then prefer unilateral action as a less costly option. Indeed, this was the Dutch justification for their ultimatum (Fortis 2008:17), confirmed by the Dutch Finance Minister who argued that '[the Dutch side] had managed to buy the better part of Fortis, leaving the worse one to the Belgians' (Beck et al. 2010: 73).[6]

This view was disputed by the Fortis as well as the Belgian authorities, who argued that a substantial proportion of the emergency credit lines granted to Fortis Bank by the Belgian National Bank had actually served to finance the Dutch banking operations (Fortis 2008). The Fortis directors and Belgian authorities could, of course, refuse to approve the sale of the Dutch assets and try to renegotiate the Dutch ultimatum. However, there was little time under the pressure of the escalating crisis and the risk of delaying action was too high. When the Dutch agreed to increase the offer from €9 bn to €16.8 bn, the Belgian side agreed to the unilateral resolution.

Given the belief of the Dutch authorities in the viability of the Dutch parts of Fortis, their decision to pursue unilateral action seems legitimate. The Dutch, as well as other national authorities, are bound by their national mandates to ensure financial stability and, if a fiscal intervention becomes necessary, to minimize its impact on domestic taxpayers. If the Dutch

[5] The fact that the retail operations of the ABN AMRO were not yet integrated into the Fortis group limited the costs and complexity of the Fortis break up.

[6] The Minister of Finance also pointed out that the Dutch authorities joined the negotiations only on 28 September, when they advanced towards a solution that did not give the Dutch control in all entities they cared about (Het Financieele Dagblad, Dec 24, 2008). They were offered 49% in Fortis Bank Netherlands, but ABN AMRO and Fortis insurance in the Netherlands remained under control of the Fortis entity in which the Belgian authorities invested. There was no time to renegotiate before the announcement of the plan.

authorities judged multilateral action as more risky and expensive, they would – in the absence of any rules committing them to minimize the overall resolution costs – breach their fiduciary duties by agreeing to it.[7] The same logic applies to the Belgian authorities providing that they judge the price of the buyout of the Dutch parts as adequate. The problem of such an agreement may arise only if one or both sides misjudge the value of assets and the expected resolution costs due to uncertainty during a crisis. In such a case, one side may end up providing a massive cross-border subsidy towards the resolution costs, which may strain future relationships.[8]

The 3 October agreement clearly does not constitute cooperative multilateral resolution (M,M). But does it correspond to the unilateral Nash equilibrium (U,U)? In the absence of binding rules, the Dutch and Belgian authorities resorted to national resolutions, which was their less-preferred option as it destroyed the cross-border franchise of Fortis. However, there is also a possibility that one government emerged from the crisis better off then the other, corresponding to the (U,M) or (M,U) outcomes of the game. This ultimately depends on whether the Dutch paid a fair price under the circumstances (U,U) or overpaid, in which case they implicitly subsidized the resolution costs in Belgium (U,M), or underpaid, in which case the implicit subsidy goes in the other direction (M,U). This will become clearer after the Benelux authorities dispose of assets acquired in the transaction and estimate the total costs of the Fortis resolution. Immediately after the transaction, the Belgian side feared that Fortis' assets were sold at too low a price and a greater part of the resolution burden remained with them.[9]

Whatever the case may be, the Fortis resolution has clearly shown that the pre-crisis EU cross-border bank resolution regime was not robust enough to support the most efficient cooperative multilateral resolution. The communication procedures did not ensure full access

[7] The Dutch were partially vindicated in their preference for unilateral resolution by the fact that they avoided the difficulties that the Belgian side experienced in obtaining shareholder approval for the sale of Fortis to BNP Paribas.
[8] The UK and Dutch subsidy towards the resolution of the Icelandic banks' branches in these countries has put their relationship with Iceland under strain. Two years after the event, they are still trying to reach agreement on the repayment schedule.
[9] When the sale was announced, the *Financial Times* questioned several market participants who argued that the Dutch bought the Fortis assets at a discount of as much as €10 bn (FT Oct 4, 2008).

to initial negotiations, which made the original plan unacceptable to the Dutch. The MoUs burden sharing rules were either non-existent or not helpful in the negotiations of a multilateral resolution under severe time pressure. The agreed *ad hoc* solution will prove acceptable, only as far as it strikes a reasonable balance in terms of sharing the fiscal burden of the resolution. Moreover, the sale was accepted only after a unilateral threat to seize the Dutch assets by forced administration; had the Dutch authorities not been flexible on price, the situation could have ended up in a deadlock inviting chaotic collapse and sharp conflict between the Dutch and Belgian authorities. Overall, the Fortis case represents a successfully managed failure of the EU cross-border resolution regime that in actuality could end up a lot worse.

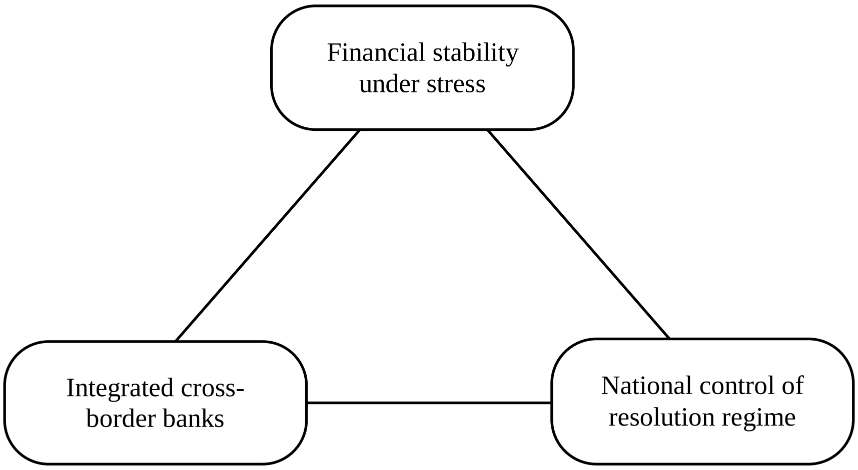
The prisoner's dilemma outlines the conflicting incentives arising from the mismatch between the national accountability of resolution authorities and the cross-border character of banks. On a more general level, this represents the conflict among the three objectives of EU policy that aims to foster financial stability and cross-border banking, while respecting national bank resolution regimes. This conflict is well captured by the concept of the globalization trilemma that also delineates the policy space for post-crisis reforms.

4. A POLICY TRILEMMA

The policy trilemma states that only two out of the following three policy goals can be achieved simultaneously (Rodrik 2000, Schoenmaker and Oosterloo 2008): (i) stability of the banking system under stress, (ii) sustaining an integrated cross-border bank under stress and (iii) maintaining national control over the bank resolution regime. The first goal is self-evident; the whole purpose of banking regulation, supervision and resolution regimes is maintaining financial stability. The second goal is implied by the Single Market objectives of the Treaty, which aims to establish the freedom of capital movement and freedom to provide services across the EU. The third goal is not an objective in its own right; rather it is a corollary of member states' desire to maintain control over their fiscal outlays and prevent the EU from making fiscal commitments on their behalf.

The trilemma implies that there are three possible outcomes. First, the EU may achieve its objectives of financial stability and integration, but sustaining these two goals under adverse market conditions would require member states to support a resolution regime for cross-border banks on the EU level (outcome 1, Figure 2). Second, financial stability under stress can be maintained if banks operate as nationally incorporated units with full operational and financial independence, i.e. they are not fully integrated in the internal structure of the transnational financial group, and thus their resolution can be performed on the national level without large externalities imposed on other countries (outcome 2). Third, integrated banks can be supported by a national resolution regime, but only at the expense of higher risk that their stability will not be maintained under difficult market conditions (outcome 3). The first outcome is the one to which the EU aspires. At the same time, it struggles to overcome the legal and political constraints associated with this option. The second outcome would largely mean a return to the pre-1992 situation when banking markets were mutually open, but cross-border banks were not operationally integrated. Finally, the third outcome is what was in place before the current crisis.

Figure 2: Possible outcomes of the trilemma



Outcome 1	Outcome 2	Outcome 3
Lower risks of instability under stress	Lower risks of instability under stress	Higher risk of instability under stress
Integrated cross-border banks	'Subsidiarized' cross-border banks	Integrated cross-border banks
EU-level resolution regime	Country-level resolution regime	Country-level resolution regime

The Fortis case supports the validity of the trilemma as it shows that the national accountability of regulators and treasuries made it impossible to sustain financial stability without breaking the cross-border banks into national parts. Unless the post-crisis reform shifts the resolution regime up to the EU-level or back to the national level, the trilemma would suggest that the breakup of cross-border banks is the most likely outcome of the resolution process. The trilemma thus delineates the policy space for debate on post-crisis reform of the cross-border bank resolution regime in the EU.

5. POST-CRISIS REFORMS

The answer to the absence of a robust cross-border resolution regime before the crisis lies as much in the complacency caused by the previous long period of financial stability as in the method of European integration. The EU had experienced occasional crises with cross-border implications before the financial crisis of 2007-2009. Failures of EU-based banks like Herstatt Bank, BCCI or Credit Lyonnais triggered regulatory responses formulated on the global as well as the European level. However, such isolated incidents did not seem to merit the effort required to develop a cross-border resolution regime. This perception began to change during the pre-crisis decade as banks expanded across borders.

The traditional EU strategy is to put market integration first and integrate the underpinning institutional framework only in response to market integration (Sandholtz and Stone Sweet 1998). It tends to create a virtuous cycle if market forces support the successive steps of institutional integration as it becomes necessary to proceed beyond the harmonized minimum. However, such an approach creates regulatory gaps, if market actors can no longer be effectively regulated on the national level, but there is not yet any reasonable EU-level regulation.

The Commission avoided putting the cross-border resolution regime on the legislative agenda, because the informal response from member states was consistently negative (Speyer and Walter 2009). Similarly, when the ECB tried to expand on the limited financial stability mandate given to its Banking Supervision Committee the Maastricht Treaty, the Eurozone as well as the UK pushed back vigorously (Posner and Veron 2010). As a result, there was no binding legal framework for bank resolution before the crisis and the Eurosystem central banks were limited to their role of lenders of last resort.

The crisis experience offered an opportunity to reconsider the bank resolution framework. It created a policy window for the Commission to try to propose more radical reforms. The remainder of this paper reviews the Commission’s Communication on An EU Framework for Cross-Border Crisis Management in the Banking Sector. We ask whether the Commission considered any of the polar options suggested by the trilemma and specified in the academic literature and related policy reports.

6. THE EU-LEVEL RESOLUTION REGIME

The EU-level resolution regime for cross-border banks represents the first-best solution from the point of view of economic efficiency. It would allow for internalization of positive externalities, such as efficiency gains from cross-border integration, as well as negative externalities, such as contagion in the case of financial instability. It would permit resolution strategies that minimize the overall costs of bank resolution and prevent national responses that minimize national costs while increasing overall costs. In its most extreme form, the EU-level resolution regime would be operated by a European Financial Supervision Agency that would operate according to EU law and be backed by EU-level fiscal capacity.

Schoenmaker (2009) explores the possibilities of creating a single EU financial regulator and proposes a similar process that led to the institutionalization of the ECB. However, he also points out that there is no Treaty base for a single financial regulator. The limited financial stability mandate that the Treaty confers on the ECB can be expanded neither to non-banking financial services, such as insurance and securities, nor to non-Eurozone countries. Thus, a change in the Treaty is a prerequisite for the creation of a single EU regulator that could avoid the conflict of incentives stemming from the national mandates of resolution authorities.

The rules for the resolution of cross-border banks could be provided by the '28th' EU-level legal regime operating alongside the national banking laws. Cihak and Decressin (2007) discuss the potential benefits of a European Baking Charter that would allow national banks to stay within the national regime, whereas cross-border banks could either accept an EU-level regime or organize themselves as a holding company of national banks. They argue that creating an EU-level legal regime is more plausible than full harmonization of banking regulation, supervision and resolution across the EU. However, even if the resolution of cross-border banks is specified in a directive, fiscal backing is still necessary to make it operational.

Goodhart and Schoenmaker (2009) explore two possible mechanisms for EU-level fiscal burden sharing. The first proposal is based on full solidarity between EU member states; the second is specific to countries in which the given cross-border bank is present. Both mechanisms assume that either the ECB or the European Investment Bank (EIB) would be given the right to issue bonds to finance a cross-border resolution. The bonds would be guaranteed jointly by member states according to some capital key based on GDP shares and other variables. In the case of full solidarity, all EU members would guarantee and finance the scheme; in the case of a specific mechanism, only those where the cross-border bank operates would provide financing. However, as Goodhart and Schoenmaker (2009) also point out, such a scheme would violate the Treaty prohibition on financing fiscal outlays through monetary financing. This could be avoided if the scheme is pre-financed via bank resolution funds subsidized by a levy on banks (see Commission 2010). Alternatively, fiscal backing could rely on bond guarantees provided directly by each member state in a similar manner as the €440 bn guarantee behind the European Financial Stability Facility outlined in May 2010 to manage the Greek crisis.

Even if the funding issue was resolved, member states would still have to agree on the formula distributing the losses incurred by the EU-level scheme. A simple formula based on GDP or another variable is unlikely to be politically acceptable, as it would be insensitive to the importance of a given bank to any given economy. It would also create a moral hazard problem if states reduce efforts and resources dedicated to the supervision of banks, as they would no longer bear the full cost of the resolution. A more plausible formula would involve only member states where the cross-border bank has a substantial market presence and would be based on number of relevant variables. The 2008 MoUs suggested burden sharing based on the expected economic impact of cross-border bank failure on the member states concerned and the allocation of home and host supervisory responsibilities among member states. The De Laroisiere report (2009) suggested expanding the list of principles by some of the following criteria: the deposits of the institution; assets; revenue flows; the share of payment system flows; the division of supervisory responsibility with the party responsible for supervisory work, analysis and decisions being also responsible for an appropriately larger share of the costs. Goodhart and Schoenmaker (2009) suggested a quantifiable formula based on average foreign assets to total assets, foreign income to total income, and foreign employment to total employment within the banking sector of a member state, while all other suggestions remain quantified and subjected to policy debate.

Although the EU-level resolution regime has been outlined in the academic and policy literature, it has so far failed to address the key issues of legal foundations for a single EU financial supervisor, raising funding for bank rescues and sharing the fiscal burden. The policies suggested in the literature would require important legal changes, and the crisis experience did not seem to create sufficient political momentum to introduce them. In this respect, the crisis did not create a policy window for the introduction of a EU-level resolution regime. The Communication on Cross-Border Crisis Management (Commission 2009) as well as other policy reform proposals refer to EU-level policy options, only to dismiss them as politically and legally implausible. At the same time, the political momentum behind a levy on banks or the need to defend the stability of the Eurozone would allow for the creation of a new funding mechanism that could be used.

7. RETURN TO NATIONAL RESOLUTION REGIMES

Splitting cross-border banks into a network of independent national entities is the polar opposite of an EU-level resolution regime. Such a reform would force banks to reorganize so that their operations, regulation, supervision and resolution would be conducted strictly on a national basis. This option – dubbed subsidiarization – would substantially reduce the mismatch between cross-border banks and national regulations by making banks national. There would be no need for a cross-border regime, as banks would be resolved by national authorities, according to national rules and with national fiscal resources.

Many aspects of the current EU framework for retail commercial banks are compatible with subsidiarization. National subsidiaries – but not branches – of cross-border banks must meet all criteria for a banking license, thus they have formally independent management and governance systems and capital bases to meet prudential requirements. Although formally separate, many of the operational processes are centralized in practice, as was the case with Fortis banks. Subsidiarization would impose the onus of reforms on cross-border banks that would have to decentralize and undo their internal integration.

The UK's Financial Services Authority (FSA 2009) brought subsidiarization into debate. It reflects the UK's experience during the crisis when its government bore full costs of stabilizing interventions in UK-based banks, but the benefits were spread across many of their cross-border counterparties. Moreover, the UK was also confronted with the situation when Iceland, as the home country of Icelandic banks, could not afford to rescue them or even pay out the mandatory deposit insurance. This only added to the fiscal strain of UK banking bailouts and led the FSA to put subsidiarization on the table.

Large international banks immediately countered the idea, arguing that even if national subsidiaries were connected only by brand name, there would still be cross-border spillovers (IIF 2009, Ackerman in the Financial Times, 29 July 2009). In their view, subsidiarization would undo the achievements of EU banking integration without addressing the lack of internationally coordinated crisis management. The former argument resonated with the Commission, which is keen to preserve banking integration. In its Communication, the Commission argued that confining banking assets to single jurisdictions would inevitably translate into restrictions on the cross-border provision of services or establishment, and thus dismissed subsidiarization on legal grounds (Commission 2009).

On the other hand, the subsidiarization idea resonated within the EU host countries that were keen to protect their local subsidiaries, comparable to the Dutch authorities in the Fortis case. They insisted on bolstering their liquidity and capital positions given the new risks generated by the crisis, and were prepared to scrutinize carefully any intra-group transfers that trapped liquidity – which could be used for stabilization of the whole cross-border financial group – in its subsidiaries (Unicredit 2009). Paradoxically, subsidiarization could be reinforced by the Commission proposals for an EU network of national bank resolution funds (Commission 2010a). The Commission views these proposals as a stepping-stone towards an EU Resolution Fund, but national pots of liquidity are likely to strengthen national accountability for resolution and undermine incentives for cross-border cooperation.

The crisis experience led the Commission to consider the subsidiarization option, but only to dismiss it on legal grounds (see Figure 3 for a summary). The Commission staff argued that returning the resolution regime to the national level would require modification of the Treaty that could undermine the internal market (Commission 2009:39).

Figure 3: Polar policy options compared

Criteria	**EU regime**	**National regime**
Characteristics	- Single EU regulator - EU resolution laws - EU funding scheme	- National authorities in charge - Single passport restricted - National financing only
Reform implications for cross-border banks	- Comply with EU bank charter (“28th banking law”)	- Turning branches to subsidiaries - Restoring operational independence of subsidiaries
Reform implications for member states	- Outsource resolution to EU bodies - Accept the fiscal implications	- No need for cross-border regime - Responsibility and costs fully on national level
Legal constraints	- No Treaty-base for single EU supervisor - Financing may violate the Treaty	- Restricts internal market freedoms - Difficult for non-retail firms
Political constraints	- No agreement on burden sharing formula	- Global banks oppose - Commission not keen

8. TRADITIONAL RESPONSE: GOVERNANCE INNOVATIONS AND MORE SOFT LAW

The favorite response of the EU to challenges arising from the financial sector is to ask a committee of wise men what should be done. The most recent example is an *ad hoc* high-level group on financial supervision chaired by Jacques de Larosiere that was asked to suggest the post-crisis financial sector reform agenda. The committee deliberately avoided politically contentious issues, such as the introduction of a single EU supervisor and fiscal burden sharing, and focused instead on two new governance mechanisms that also have a bearing on the cross-border resolution regime (de Larosiere 2009).

The committee proposed establishing a European Systemic Risk Board (ESRB) charged with identifying risks in the system and issuing warnings that the relevant authorities would have to explicitly address. Furthermore, it recommended developing a European System of Financial Supervisors (ESFS), which would be charged with coordination in emergency situations and resolution of disagreements among national supervisors. At the core of the ESFS proposal is the transformation of the existing Level 3 Lamfalussy committees into European Supervisory Authorities, so that the current Committee of European Banking Supervisors would become the European Banking Authority (EBA). The EBA would not only receive an independent chairperson, staff, legal status and EU funding, but also increased powers to coordinate the work of national supervisors, especially during crises with cross-border implications. Importantly, the EBA would also be able to impose mandatory mediation of disputes among national supervisors. Its additional duties would include the development of a harmonized EU rulebook on financial supervision, supervision of credit rating agencies and developing an EU-wide database of confidential prudential information (Commission 2009).

The EBA can impose binding obligations on national supervisors only if they disagree among themselves or if the Commission declares an emergency situation. In the case of disagreement, the EBA's decision-making body, which comprises its chairperson and heads of national supervisory authorities, can adopt binding arbitration decisions by qualified majority vote (Gros 2009). In an emergency situation, the EBA may assume a coordinating role between national supervisors and adopt decisions requiring national supervisors to take action. These powers are, however, subject to a number of political safeguards, including a fiscal clause declaring that its decisions may not in any way impinge on the fiscal responsibilities of member states. It was introduced at the insistence of the UK, which refused to accept any EU-level rule that could result in binding fiscal commitments (EurActiv Dec 3, 2009). The UK has also insisted on additional "triple-lock" safeguards that can undo the EBA's decisions. The first is the right of any member state to appeal to the Economic and Financial Affairs Council to suspend any EBA decision; the second is the right of a simple majority of at least 14 member states to overturn an EBA decision; and the third is the right of any member state to appeal to the European Council, if the first two options fail.

The ESFS and EBA proposals reshape the governance arrangements but fall short of specifying any legislative rules guiding cross-border resolutions. The rules are derived only from the MoUs that call for, but do not prescribe, 'voluntary specific cooperation agreements'. In its Communication, the Commission considered the compulsory introduction of recovery and resolution plans ('living wills') for all cross-border banks. Making banks responsible for such plans could ensure that the voluntary agreements are actually developed and agreed upon within the colleges of supervisors (see Avgouleas et al. 2010).

The ESFS/EBA regime and associated improvements in soft law rules could resolve the prisoner's dilemma by providing effective communication and credible commitment to *ex ante* rules. However, numerous safeguards reduce the credibility of the EBA's powers. Moreover, the proposed governance arrangements remain punishingly complex, which is likely to render them inefficient under the time pressure and uncertainty of banking crises. These improvements are unlikely to be equivalent to an EU-level resolution regime, thus the trilemma logic would still predict recourse to unilateral resolution of cross-border banks.

9. CONCLUSION

The crisis experience in general and the Fortis experience in particular made a strong case for the reform of the EU cross-border bank resolution regime. The Commission reflected on this crisis as well as on the reform options suggested in the literature. Ultimately, the Commission concluded that the political and legal constraints that prevented the adoption of the more robust pre-crisis regime remain firmly in place. Therefore, the crisis experience did not pave the way for more radical reforms, and the proposals in the Communication stick to the traditional recipe of deepening existing soft law and strengthening the pre-crisis governance framework. The initial response of the Council to related proposals on the financial supervision architecture also indicates that the traditional concerns over the fiscal sovereignty, on one hand, and market freedoms, on the other, will prevail. In short, the crisis experience did not lift any of these constraints and thus did not open a policy window for path-breaking reforms.

The EU is set on the reform path that relies on voluntary cooperation underpinned only by soft law rules and punishingly complex governance structures. These are not well suited to support multilateral resolution of cross-border banks that must be decided by national authorities under the severe time pressure and uncertainty of acute crisis. At the same time, the outcome of negotiations among the Commission, Council and European Parliament may be different from the original proposal. Moreover, the recent shift towards more supranational governance of the Eurozone, and the likely institutionalization of the European Financial Stability Facility introduced in response to the aftershocks of the financial crisis, may open an additional policy window for the reform of the EU cross-border bank resolution regime. These developments, together with strong lobbying of transnational banks, may shift the politics of reform towards a more supranational regime. On the contrary, should any of these responses to emergencies fail, the pendulum of regulatory reform may swing towards national solutions. What is certain, for now, is that the initial crisis experience was on its own insufficient to encourage more radical reform proposals.

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