Cross-border financial crisis simulation exercises

Testing the interaction between authorities of countries with significant banking interlinkages

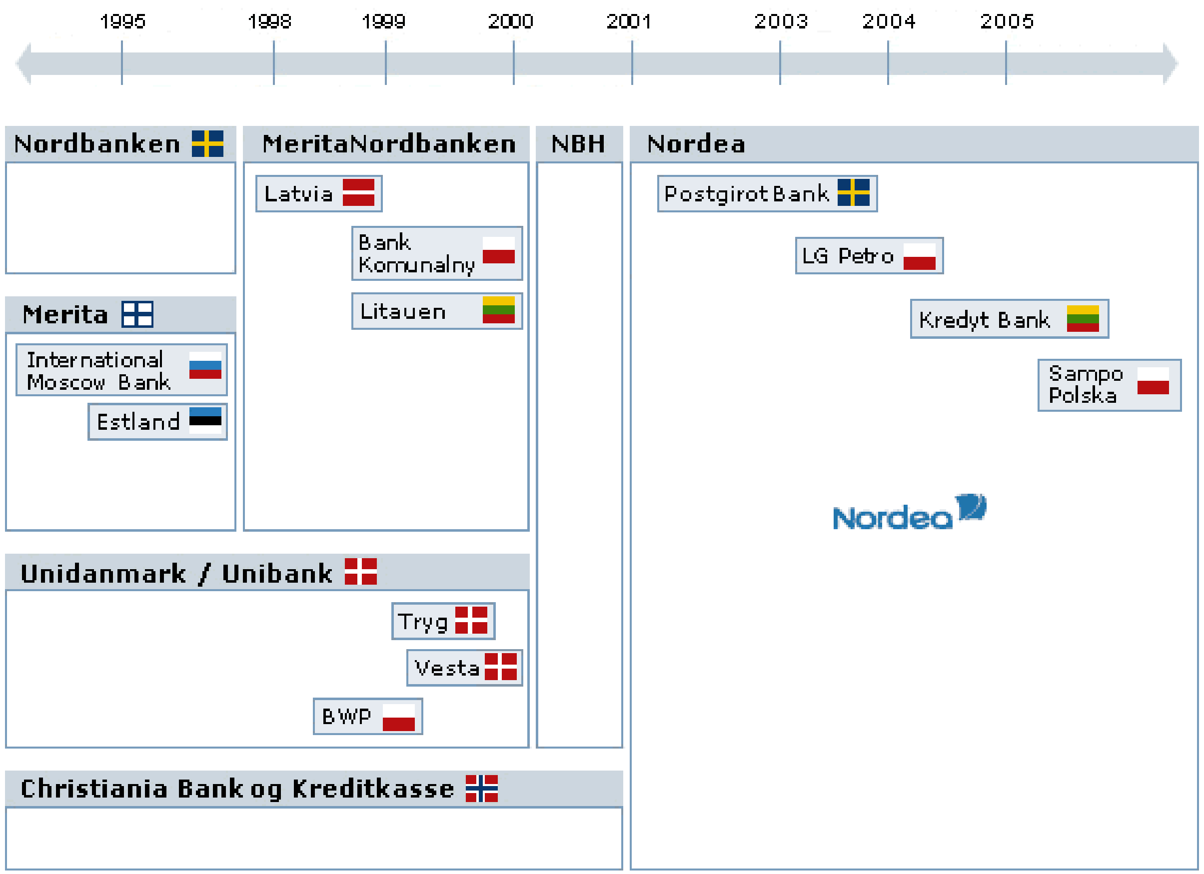
Thorvald Grung Moe, Norges Bank

The views expressed do not necessarily correspond to those of Norges Bank

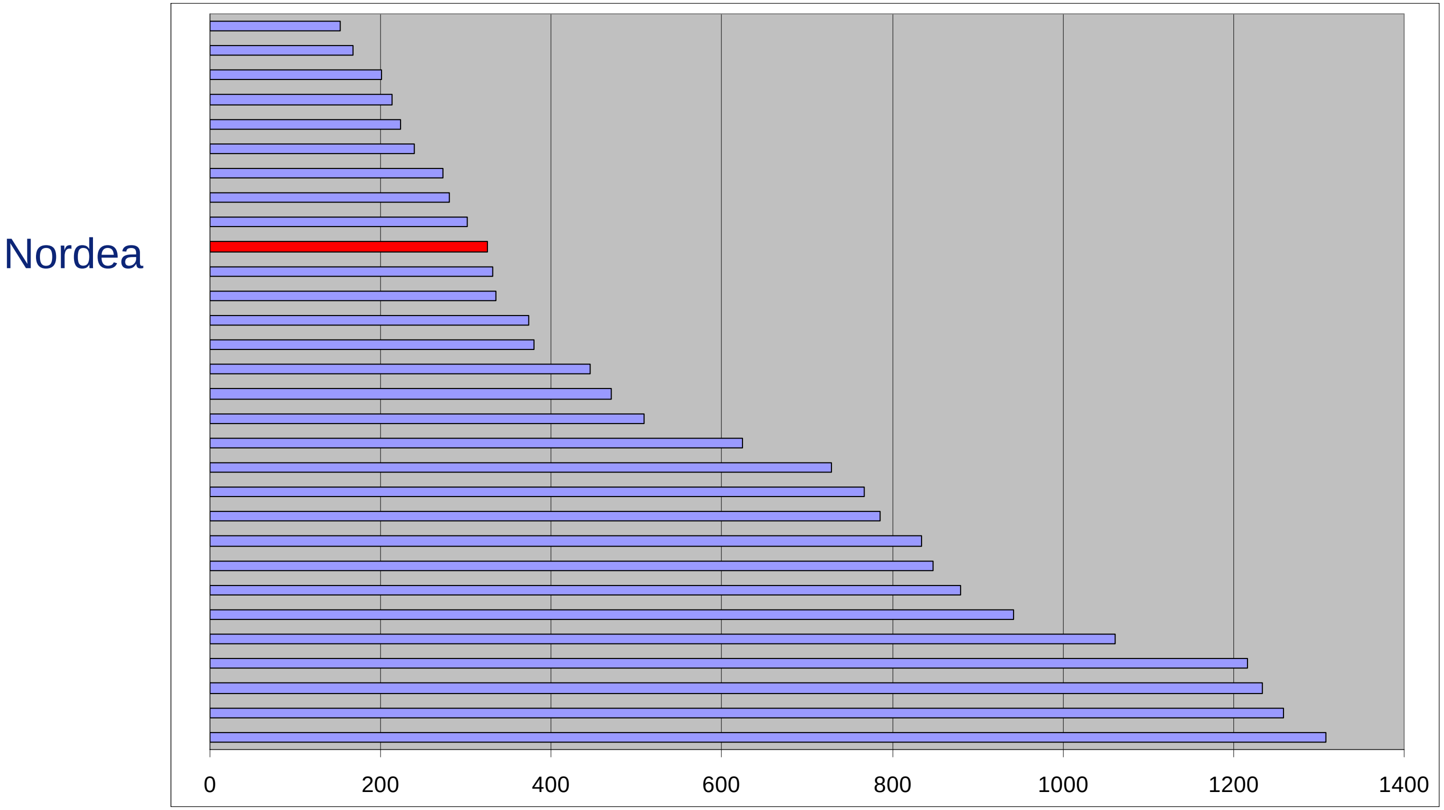
Outline

- The Nordea case
- The 2002 Nordic simulation exercise
- Lessons learnt
- Regional policy issues
- The next Nordic-Baltic simulation exercise
- Challenges ahead

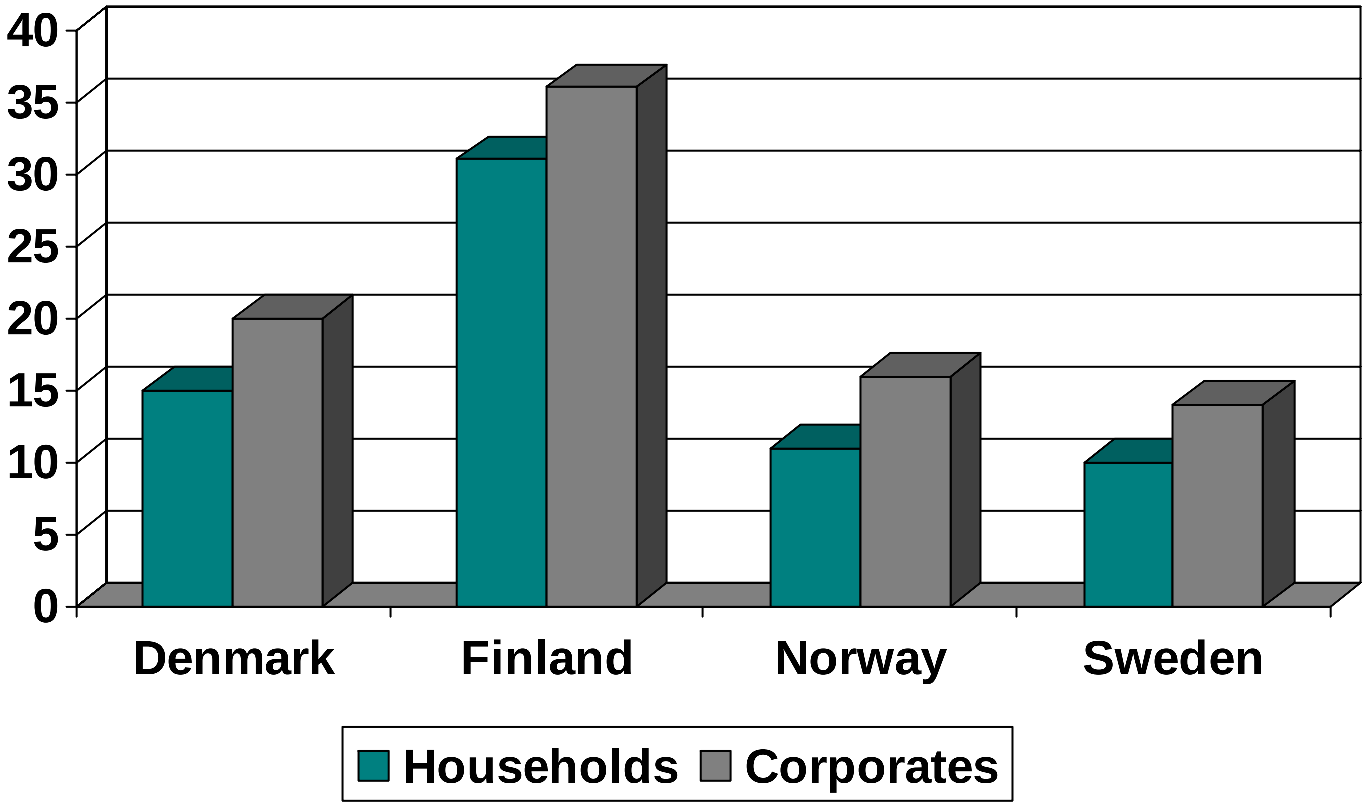
Nordea – the formation



Ranking of banking groups in Europe
by consolidated balance sheet (€ billion), end 2005



Nordea – market shares (2006)
(%)



The 2002 crisis simulation exercise

- 1 day in Norges Bank
- 24 participants from 4 Nordic countries
- Only central bankers and supervisors
- Split in 3 groups
- 3 phased scenario; “solved” on-site
- First phase received ahead of time
- “Real numbers” = Nordea (they were informed)

Three different phases of the crisis

Phase	Main events	Response
1	• **Rough trader in parent bank** • Capital still OK • ELA application to Riksbanken	• No need for ELA (yet) • Enough collateral • Common problem!
2	• **Rough trader also in one sub** • Strong neg. market reactions • Internal transfer of assets	• ELA from parent (FI)? • Collateral transfer? • Ring fencing?
3	• **More losses/inadequate capital** • Payment system problems • New ELA application (more)	• Liquidity guarantee? • Contact M of Fin • Capital from owners?

Lessons learnt

- Everybody agreed that the simulation exercise was very useful!
  - Identified problems in extending ELA to a large cross-border bank
- The crisis simulation exercised highlighted the potential for ringfencing
  - Problems with national mandate for supervisors, transfer of assets and “trapped pools of collateral”
- The exercise also highlighted the importance of being well prepared
  - Follow-up work on practical aspects of ELA-, deposit insurance- and closure policy

Crisis simulation exercises as a learning process

- Explore interactions and strategic behavior - to well known crisis scenarios
  - Preparation, execution and follow-up
- Explore new crisis scenarios and test commonly held hypotheses about how a crisis will develop
  - Thinking the unthinkable!

Regional policy issues

- Parent bank support for subsidiaries?
  - Moral responsibility vs. limited liability
- Home authority support for subsidiaries?
  - Is the bank systemic in all countries?
- Home DGS support for branch deposits?
  - When subsidiaries are transformed into branches

Parent support for subsidiaries?

- 100 % owned
  - Parent bank has equity, funding and reputation at stake
- Parent has informational advantage
- Subsidiaries often operate “as branches”
- Weak legal basis, but “moral responsibility”

Home authority support for subsidiaries?

- *… would we in Sweden be willing to resolve a banking crisis in Finland, with all that it would ask of the Swedish taxpayers, if Nordea were to run into difficulties? The answer to this question is not straightforward.*

Riksbanken (2003)

Home DGS support for branch deposits?

Nordea Press release

- Nordea announced in June 2003 its intention to form a European company.
- The aim is to establish a one-bank structure, with one legal entity conducting business in all local markets through branches.

- *It could be questioned if it is reasonable that, after a large bank failure, the authorities in the host country just refer its depositors to the home country authorities, without taking any responsibility.*

Riksbanken (2005)

The next simulation exercise

- Later this year
- Prepared by *Crisis Management Analytics (UK)*
- 5 x 3 Nordic authorities + Baltic observers
- Key topic: Burden sharing!
- Also test of systemic assessment framework

Can we agree on burden sharing?

- *Only once burden sharing arrangements have been clarified, can the longer term issues (of deposit guarantees) be addressed.*

EU Commission (2007)

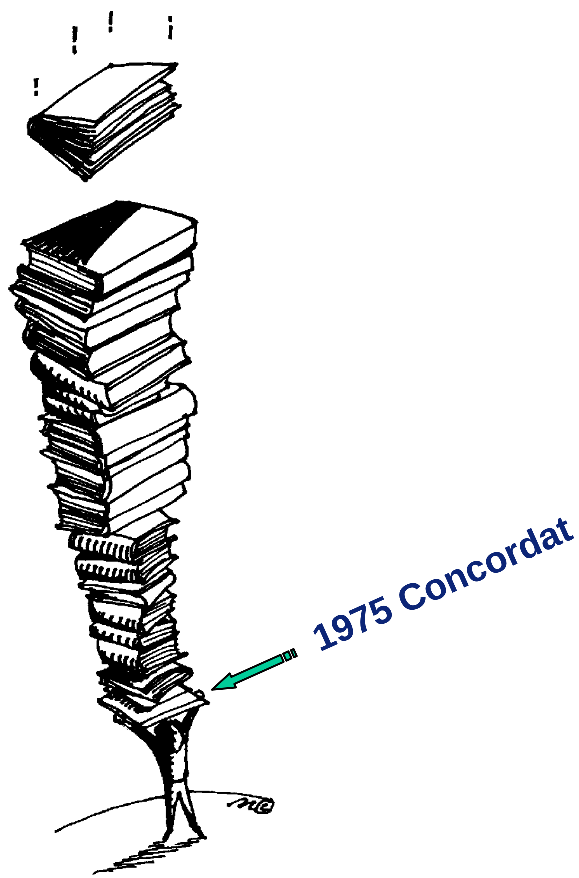
Challenge ahead

- How to create simple, realistic and useful simulation exercises?
- Simulation exercises are good at identifying difficult policy issues, but not at solving them.
- How can we solve the home-host conundrum?

The home-host issue conundrum

- *The interaction of an internationally inter-penetrated banking system with a system of national supervision and national burden allocation could well turn out to be a dangerously weak institutional feature.*

Charles Goodhart (2005)



Two different approaches

- Centralized approach
  - …"the financial stability framework (in EU) should be built upon a foundation of joint responsibility and joint accountability for large cross border financial institutions."

    IMF (2007)
- Decentralized approach
  - … any further shift in supervisory powers requires a prior debate and greater clarity about which Member State would pay the fiscal burden if a cross border bank failed.

    EU Commission (2007)

Suggestion: “Get the prices right”

- Decentralized “EU approach” could led to “IMF optimum” if the incentives are right
  - Expand national mandates
  - Legal form should reflect business reality
  - Bank capital should better reflect (large) cost of financial crisis

Summary

- Crisis simulation exercises are very useful
- They have highlighted important policy issues and triggered practical follow-up work
- EU has actually come a long way in addressing the home-host conundrum
- Decentralized approach possible, provided "prices are right"
- Crisis simulation exercises makes us all better prepared for the next crisis – when it comes

Be prepared!

To be prepared at any moment to face difficulties and even dangers by knowing what to do and how to do it.

Baden-Powell (1910)