

## D FINANCIAL RESOLUTION ARRANGEMENTS TO STRENGTHEN FINANCIAL STABILITY: BANK LEVIES, RESOLUTION FUNDS AND DEPOSIT GUARANTEE SCHEMES

*Fundamental reforms of regulation and supervision are currently under way – both at international and European level – to address the deficiencies exposed by the financial crisis. In this context, a range of policy approaches have been developed, aimed at mitigating the burden on taxpayers and minimising future reliance on public funds to bail out financial institutions.*

*This special feature examines the recent initiatives undertaken by several EU Member States to implement bank levies and resolution funds, in some cases exploiting synergies with deposit guarantee schemes (DGSs). These financing mechanisms are fully supported by the European Commission in the context of the proposed EU framework for bank recovery and resolution.*

### INTRODUCTION

In order to improve crisis resolution mechanisms, to reduce moral hazard and build up financial buffers against possible future crises, the G20 leaders – at their June 2010 Toronto meeting – undertook to develop a new policy framework. They also agreed that the financial sector should make a fair and substantial contribution towards paying for any burdens associated with possible government interventions, where they occur, to repair the financial system or fund resolution.<sup>1</sup> Countries intending to implement measures to this end should respect a number of principles to ensure a minimum level of coordination.<sup>2</sup>

In the course of 2010 broad support for private sector contributions was also expressed by international financial institutions such as the International Monetary Fund (IMF), the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS).<sup>3</sup>

In the EU, even more precise guidance was provided by the European Council to the

Member States in its conclusions of 17 June 2010: “Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk.<sup>4</sup> Such levies or taxes should be part of a credible resolution framework. Further work is urgently required on their main features, and issues relating to the level playing field and the cumulative impact of various regulatory measures should be carefully assessed.”

In accordance with these European Council conclusions, several Member States have already established or begun to develop a country-specific system whereby national financial sectors will help to bear the net cost of a financial crisis. Other Member States are actively considering the introduction of such measures and are likely to follow this lead.

This special feature provides an update on the ongoing initiatives to implement bank levies and resolution funds in the Member States. These plans are part of a broader range of initiatives to strengthen financial stability in the EU. When assessing whether to introduce ex ante financing arrangements for bank resolution funds, full account should be taken of the effects of the pending major overhaul of the prudential framework, aimed at strengthening the resilience, safety and soundness of the banking system. To that purpose, the European Commission also

- 1 G20 Toronto Summit Declaration of 26-27 June 2010.
- 2 The principles on levies and taxes agreed by the G20 are the following: i) protect taxpayers; ii) reduce risks from the financial system; iii) protect the flow of credit in good times and bad times; iv) take into account individual countries' circumstances and options; and v) help promote a level playing field.
- 3 The IMF's support for measures related to levies and taxes was expressed in its final report for the G20 entitled “A Fair and Substantial Contribution by the Financial Sector”, June 2010. In their joint paper on capital and liquidity surcharges and financial levies and taxes, the IMF, FSB and BCBS emphasised that any levy should be accompanied by the creation of an effective resolution regime; that it should ideally be designed as a risk-based charge; and that an ex ante levy would avoid survivor bias and be less pro-cyclical than ex post measures. See also *Draft ECOFIN report – Preparation of the European Council on the state of play on measures in the financial sector in response to the crisis*, 2 June 2010, 10361/10.
- 4 In the same conclusions, the Czech Republic reserved its right not to introduce these measures.

considers private financing arrangements to be an important part of the new crisis management and resolution framework.

### BANK LEVIES AND TAXES

Although the working assumption – as a follow-up to the June 2010 European Council meeting – is that Member States<sup>5</sup> should introduce a system of levies or taxes, no deadline has been set for their implementation. So far, eight Member States have introduced a bank levy *stricto sensu* (Germany, France, Latvia, Hungary, Austria, Portugal, Sweden and the United Kingdom – see Table D.1).<sup>6</sup> Other countries are in the process of introducing systems of levies and taxes (e.g. Cyprus, Lithuania and Slovenia). Some Member States are in favour of, or might consider, introducing systems of levies or taxes at a later stage when there is more clarity in terms

of: i) EU coordination; ii) the interference of a levy or tax with other regulatory measures; and iii) the potential credit supply effects of a levy or tax. Finally, a few Member States would consider introducing them in the context of an EU-wide approach to crisis resolution.

In most of the above-mentioned countries, the approach based on imposing a levy on banks is broadly favoured over a financial transaction tax (also known as a Tobin tax).<sup>7</sup> A financial

<sup>5</sup> Except for the Czech Republic.

<sup>6</sup> Denmark and Belgium have introduced levies in the context of DGSs. In Denmark, these measures include *ex post* funding.

<sup>7</sup> Recently, there has been renewed interest in the introduction of a global tax on financial transactions as a means of reducing the size of the financial sector and deterring excessive risk-taking. The tax would be a sort of generalised Tobin tax, which would be levied on a broader set of financial transactions than foreign currency transactions alone, as originally proposed by Tobin.

**Table D.1 List of bank levies in place**

(March 2011)

	Destination of proceeds	Duration	Scope	Base
DE	Stability fund	Permanent	All banks	Liabilities excluding capital and deposits + derivatives
FR	General budget	Permanent	All banks with risk-weighted assets over €500 million	Risk-weighted assets
LV	General budget	Permanent	Credit institutions	Liabilities excluding equity capital, deposits subject to a deposit guarantee scheme, mortgage bonds and subordinated liabilities
HU	General budget	Temporary	Credit institutions, insurers, other financial organisations	Unconsolidated (modified) balance sheet total
AT	General budget	Permanent	All banks with liabilities above €1 billion	Unconsolidated (modified) balance sheet total + “add on” for financial derivatives on trading book
PT	General budget	Permanent	Credit institutions	Liabilities excluding tier one and tier two capital and insured deposits + notional amount of derivatives
SE	Stability fund	Permanent	All banks, other credit institutions	Liabilities excluding capital
UK	General budget	Permanent	Banks with aggregate liabilities above GBP 20 billion	Liabilities excluding tier one capital, insured deposits, policyholder liabilities and assets qualifying for the Financial Services Authority liquidity buffer

Sources: ECB opinions and publicly available sources.

transaction tax would entail great uncertainty with respect to its effectiveness, the risks surrounding its possible impact on financial market conditions, and its potential for revenue generation.

Apart from the Tobin tax, the European Commission in its 2010 Communication on the Taxation of the Financial Sector also proposed a Financial Activities Tax (FAT), to be levied on profits and wages, which might be less attuned to behavioural changes, but a more efficient way to raise money to consolidate the public balance sheet, which has been stretched by the financial crisis.

The country-specific systems envisage a levy on all banks, with France, Austria and the United Kingdom introducing a (minimum) size threshold for determining which banks are subject to the tax. Many Member States have also widened the net to include credit institutions, with Hungary extending the scope of application of the levy to other financial sector institutions, such as insurers.

In the EU initiatives, the bank levy/tax is directly linked to the objective of recouping the costs of past bail-outs (ex post levies), or financing a rescue fund (ex ante levies).

Ex ante funding may be an appropriate choice, as it diverts the cost of the crisis from the taxpayer to the financial sector. The impact on moral hazard is uncertain. On the one hand, the costs of taking on excessive risk will be immediately borne by the financial sector. This is especially true if the funding is, at least partially, contingent on the risk profile of the contributing financial institutions and targets identified sources of systemic risk such as excess leverage, risk-taking and maturity mismatches. Examples of the different approaches include higher rates for larger institutions and a fee for derivatives (Germany), different rates for different kinds of institutions, such as insurance companies and broker dealers (Hungary),

and lower rates for longer-term funding (United Kingdom).<sup>8</sup> On the other hand, the existence of a rescue fund can induce moral hazard as it makes the existence of a safety net for the financial sector more explicit. Moreover, even under a system of ex ante funding, negative externalities may remain. Financial institutions would still be able to privatise the gains of excessive risk, while transferring losses to a rescue fund.

Ex post funding is already being practised by some Member States to obtain reimbursement for their earlier efforts to keep the financial system functioning. An example is the temporary tax on bonuses paid in the financial sector in the United Kingdom and France in 2010.<sup>9</sup> However, ex post recovery charges have significant drawbacks, as emphasised by the IMF in its final report for the G20.<sup>10</sup> First, they impose a burden only on industry survivors; failed institutions pay nothing. Second, ex post financing may be pro-cyclical, requiring the industry to meet costs precisely when it is least able to do so. Thus, while they may complement a system of ex ante charges, sole reliance on ex post charges may be unwise, as ex ante funding is a crucial element of a credible resolution framework.

As a tax base, the choice of liabilities, net of equity and other insured sources of funding, appears a sensible choice in many Member States. While in principle it would be desirable to target a levy specifically on the most volatile

8 The importance of the levy being proportional to the contribution of individual banks to systemic risk is broadly acknowledged. However, this raises considerable challenges about how to define and measure systemic risk and its application into a tax. Furthermore, a levy might trigger unintended consequences, for instance by encouraging regulatory arbitrage and disintermediation.

9 The United Kingdom implemented a temporary bank payroll tax in late 2009. It taxes bank employees' bonuses above GBP 25,000 at 50%. The tax raised a net amount of GBP 2.3 billion. France followed the United Kingdom's lead and taxed bonuses above €27,500 granted to a sub-group of financial sector workers in 2009 at 50%. See "Financial Sector Taxation: The IMF's Report to the G-20 and Background Material", IMF, September 2010.

10 See footnote 3 above.

liabilities as well as on measures of maturity mismatch (hence accounting to some extent for the assets' risk profile), a pragmatic approach would be to focus on a broad definition of liability. This would also have the advantage of requiring a lower rate than in the case of a narrower base, and thus be potentially less distorting.<sup>11</sup>

#### The double-charging issue

In general, the tax parameters (base, rate and scope) of the country-specific systems differ considerably and, in some cases, are unrelated to the medium-term objective of setting up a credible resolution framework.

This has raised concerns of competitive distortions arising in the short term within the Single Market. On this issue, the European Council agreed in October 2010 that "in line with the Council's report, there should be further coordination between the different levy schemes in place in order to avoid double-charging". In December 2010 the Council underscored the need to "minimise risks of double charging and of distortions of the level playing field within the Single Market".

Across the Member States which have introduced bank levies, there are various approaches with regard to the institutions falling within the scope of the tax base. All countries include resident banks in the scope of their tax base. Some, however, also include foreign branches of resident banks and/or home branches of foreign banks. This variety of approaches leads to a large matrix of possible tax overlaps and gaps, which Member States should try to avoid. In this sense, it is relevant to keep in mind the EU's ongoing efforts to improve tax harmonisation (see "European agenda" below).

Double-charging issues involving cross-border financial institutions can arise if a country that introduces the levy also taxes:

- subsidiaries of its own financial institutions in other EU countries (which is the case for both the French and British levies);
- foreign branches of EU banks resident in that country (which is the case for Latvia, Hungary, Austria and the United Kingdom).

At this point in time, the magnitude of the double-charging tax problem, based on the limited number of levies already in place or being set up, appears to be moderate.<sup>12</sup>

However, this problem could take on larger proportions if more Member States introduce levies. Indeed, the incentives to do so tend to increase in tandem with the number of Member States imposing a levy. Overall, 21 Member States host EU subsidiaries with a total share of more than 5% of the banking sector's total assets, while nine Member States host EU branches of an equivalent significance. The potential magnitude of double-charging is therefore high, in particular if Member States introduce levies covering subsidiaries in other EU countries or branches of foreign EU banks. In this regard, EU banks with subsidiaries or branches in the central and eastern European countries appear to be most exposed to double taxation, owing to the presence of significant foreign EU subsidiaries and branches in their domestic banking sectors.

#### RESOLUTION FUNDS

For some Member States, a possible destination for the proceeds of taxes/levies would be a

<sup>11</sup> In the light of the experience during the crisis, off-balance-sheet exposures should also be included in the base of the levy, at least insofar as they have systemic implications (for instance, implicit support to asset-backed commercial paper conduits, structured investment vehicles, etc.). However, this may not be easy to implement in the near future.

<sup>12</sup> This assessment is based on a first analysis carried out on the basis of a mapping exercise of large European banking groups with significant cross-border banking activities, conducted by the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB) in 2008.

resolution fund fed by ex ante levies and based on harmonised criteria.<sup>13</sup>

The primary purpose of a resolution fund should be to mitigate the effects of a failure on different stakeholders by trying to maximise the value of a failing bank's remaining assets and to facilitate, if possible, a quick return of assets to their productive use, e.g. when selling the bank to another bank or when financing a good bank/bad bank solution. Resolution funds may also help with the transfer of assets in the case of bankruptcy. Furthermore, a resolution fund can help to lower the overall costs of resolution – since the alternative is full-blown bankruptcy – by avoiding fire sales of assets and ensuring a smoother path to a takeover or a good bank/bad bank solution.

The establishment of resolution funds in the EU should be considered as part of a broader range of initiatives aimed at strengthening financial stability. In this context, enhanced prevention measures should minimise the likelihood and severity of a bank failure. Moreover, efficient procedures leading to earlier intervention and more effective resolution mechanisms should reduce the cost of a crisis. To reduce the risk of moral hazard, it is crucial that resolution funds are not used as insurance against failure or to bail out failing banks. In addition, clear, stringent and properly communicated conditions for their use need to be defined, such as the lack of an automatic link between the fees paid in and the funds paid out to any one bank.

At the current juncture, the preference for establishing national resolution funds with EU level harmonisation with respect to their main features is a pragmatic and realistic option. It should not exclude, however, the possibility of establishing, at a later stage, a European “fund of funds” to address the issues arising in respect of cross-border banks.

A network of national resolution funds may raise coordination issues during a crisis, similar to those raised in the context of burden-sharing by public funds. It may also create serious concerns regarding the maintenance of a level playing field

across Member States. In order to address these concerns and to minimise market distortions, a high degree of cross-country harmonisation of the criteria and their application is essential.

Some Member States have already taken action to set up national resolution funds (see Table D.2). There are two bank resolution funds currently in place in the EU financed by ex ante levies imposed on banks or other types of financial institutions (Germany and Sweden), while another is planned in Cyprus. The Swedish fund is expected to be coordinated with the deposit guarantee scheme (DGS), showing that Member States aim to exploit the synergies between resolution funds and DGSs. The Banque Centrale du Luxembourg has proposed a Financial Stability Fund combining DGS and resolution fund functions.

Moreover, in the light of the European Commission's consultation on technical details of a possible European crisis management framework,<sup>14</sup> certain aspects of the implementation of resolution funding mechanisms must be examined further, such as: i) the exact purposes for which the funds might be used; ii) the trigger and timing of the intervention (with privately financed money); iii) the interaction with DGSs; iv) governance and related State aid issues; v) the basis for raising the levy from the private sector; vi) the potential pro-cyclical effects, taking into account the regulatory measures being adopted at EU level; and vii) the relation between the resolution funding mechanism and the resolution authority.

<sup>13</sup> While some Member States could find it convenient to use these contributions to reduce their public deficit, in the long run, failure to establish dedicated resolution funds may result in the financial sector becoming more dependent on public funds should new crises occur, and further reinforce the moral hazard problem associated with “too big to fail” institutions. Furthermore, there would always be a risk that levies that are accrued to the general budget without earmarking and ring-fencing could be diverted for other uses. In principle, it would be preferable that a dedicated resolution fund is created under the control of an independent resolution authority/agency which should decide on how the available resources are to be used.

<sup>14</sup> “Technical details of a possible EU framework for bank recovery and resolution”, Commission working document released for public consultation on 6 January 2011, available at [http://ec.europa.eu/internal\\_market/consultations/2011/crisis\\_management\\_en.htm](http://ec.europa.eu/internal_market/consultations/2011/crisis_management_en.htm)

**Table D.2 Overview of national initiatives on resolution funds**

(March 2011)

	Duration	Scope	Base	Measures to be financed	Target size
DE	Permanent	All banks	Liabilities excluding capital and deposits + derivatives	Creating bridge banks or acquiring participations in banks acquiring assets from failing banks; issuing guarantees for bonds issued by acquiring banks; recapitalising acquiring banks.	Respective regulation not yet decided
SE	Permanent	All banks, other credit institutions	Liabilities excluding capital	Government measures such as capital injection, loans and guarantees to support financial system.	2.5% of GDP after 15 years
CY <sup>1)</sup>	Permanent	Credit institutions	Liabilities excluding capital	Supporting and restructuring banks with capital injections and other means.	Initial target: 3% of GDP
LU <sup>2)</sup>	Permanent	Credit institutions, insurers	Not known yet	Paying out deposits and financing deposit transfers	Not known yet

Sources: ECB opinions; websites and national information notes; S. Schich and B. Kim, "Systemic Financial Crisis: How to Fund Resolution", OECD Journal: Financial Market Trends 2010/2.

1) CY resolution fund has been established by law, but its organisation and operational framework are expected to be completed during 2011.  
2) A proposal for a Financial Stability Fund combining DGS and resolution fund functions has been prepared by the Banque Centrale du Luxembourg.

### SYNERGIES WITH DEPOSIT GUARANTEE SCHEMES

As also underlined by the European Commission in its communications,<sup>15</sup> the establishment of resolution funds requires that potential synergies with DGSs are fully explored.

Indeed, the core functions and objectives served by DGSs and resolution funds can be complementary. Resolution funds, for example, can offer another way of preserving the wealth of depositors and their access to their money. Some Member States' DGSs are already active in bank resolution, such as those in Spain<sup>16</sup> and Italy.

Some Member States have voiced concerns about the difficulty of determining the right of funding for a combined resolution fund and DGS, the impact of collecting the funds, and the considerable differences in managing DGSs across Member States.

There are various approaches in the EU to the management of DGSs and resolution funds.

No prescriptive provisions should limit these arrangements as long as the objectives of the respective schemes are fully respected. Nonetheless, for a country whose DGS already performs resolution functions, the objectives of the DGS may be combined with those of the resolution fund. This simplification would benefit the whole system.

The possible sources of synergies are at least threefold. First, one operational synergy is economies of scale: a joint fund could be smaller than two separate ones and management costs could decrease, as well as the cost of collecting contributions. Making only one payment would be simpler both for administration and for the financial industry.

15 European Commission Communication on bank resolution funds of 26 May 2010, COM(2010) 254 final; and Communication on an EU framework for crisis management in the financial sector of 20 October 2010, COM(2010) 579 final.

16 Apart from its own competences on resolution, the Spanish DGS also partly finances the Spanish Fund for an Orderly Restructuring of the Banking System (FROB), which is a resolution fund that combines both public and private contributions

Second, prompt action financed by a resolution fund may be cheaper than waiting for formal bankruptcy proceedings to begin. For example, depositors could be reimbursed and asset fire sales avoided. Also, transferring assets to another bank in the context of a facilitated sale would be beneficial to depositors, who would otherwise only be protected up to a certain limit, as well as ensuring service continuity. Depositor reimbursement, transferral of assets and service continuity are aspects that DGSs already deal with, hence a resolution fund could benefit from their expertise.

Third, strong funding provisions including ex ante components increase the range of options available in resolution cases. Some DGSs are already ex ante funded, with the European Commission proposing to make this a mandatory feature,<sup>17</sup> which may be taken into account when considering resolution funding mechanisms.

Risks arise when the differences in function and scope between resolution funds and DGSs are not carefully thought through. For example, the group of member institutions are not necessarily the same. The conditions for the use of deposit guarantee funds for means of resolution have to be strongly bounded to avoid a deterioration of confidence in the DGSs.

The financial resources available for pay-out should be ring-fenced within the balance of the fund and used to cover the part of the resolution cost that indirectly ensures the depositors' protection.

Finally, ex ante funding is a crucial element of a credible resolution framework and must therefore be maintained.

#### EUROPEAN AGENDA

The harmonisation of bank levies and resolution funding at EU level is particularly important. This is because the introduction of different bank levies and resolution funds could undermine the process of financial integration by introducing

elements of fiscal, regulatory and supervisory fragmentation.

The different initiatives must be coordinated, for example through bilateral agreements. At the national level, the design and implementation of domestic schemes should ensure the necessary flexibility to facilitate a move towards greater harmonisation of both bank levies and resolution funds, e.g. by including rendez-vous clauses<sup>18</sup> or by bilateral double taxation agreements. In this respect, the European Commission supports, as a general goal, a pan-European DGS, which may also tie into resolution funding and the longer-term “fund of funds” solution. Agreement on the scope of financial levies is crucial to solve the issues relating to double-charging and maintaining a level playing field. However, it is acknowledged that the achievement of such a consensus is not realistic in the short term.

#### CONCLUDING REMARKS

The financial sector has imposed significant costs on the public by privatising profits prior to the crisis and then relying on public support to continue operations. For this reason, mechanisms have been examined both to recoup the losses of the crisis and to create provisions against future events. Ex ante funding is a crucial element since it may reduce moral hazard and improves the authorities' ability to react to crises earlier, thus strengthening the credibility of such actions. Taxes and levies are valuable revenue-raising mechanisms to finance crisis measures. Uncertainty remains on how they would affect the particular problem of moral hazard in the financial sector. In the design of taxes and levies, accumulation of different, counterproductive measures need to be avoided. However, maintaining a level playing field and coordination between Member States is paramount in order to avoid distortion of taxes, levies, fund contributions and resolution tools.

<sup>17</sup> European Commission Proposal for a Directive on Deposit Guarantee Schemes of 12 July 2010.

<sup>18</sup> These document the Member States' intention to come back to an issue for which no agreement could be reached yet.