

# **PROBLEMS WITH THE TREATMENT OF CROSS-BORDER BANKS IN THE FINANCIAL CRISIS: SOME LESSONS FOR AUSTRALASIAN FINANCIAL INSTITUTIONS**

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Fortunately it seems that Australia and New Zealand have been spared the worst of the present financial crisis and they have not had to find out whether their procedures for handling troubled cross-border banks actually work as intended. However, they have already found out that not having any form of deposit insurance seems to be an error in a crisis. Europe has not been so lucky and this paper looks at the implications of that experience for Australia and New Zealand. It focuses on three issues: the early detection of problems and their swift correction; the nature of insolvency regimes that can be run across borders and the problem of deposit insurance. In particular Europe has found that it could not act as fast as it wanted to head off problems; that some resolution techniques do not appear to work well and that state ownership and open bank assistance have proved more necessary than expected. It has proved particularly difficult to handle impaired assets and the debate about whether to set up 'bad banks' has emerged again. The paper concludes that while making sure that any systemically significant banking operations in second country should be capable of being free-standing, as required at present, that this does not overcome the problems and bank creditor recapitalisation may prove more difficult than hoped.

## **The early detection of problems and their swift correction**

It has always been obvious that if problems are detected early then it is likely to be rather easier to resolve them before a bank reaches outright failure. It is relatively rare that a bank is hit by a single shock that brings it down, as in the case of the (second) Barings failure. Normally it shows signs of poorer performance and ideally is the subject of a takeover or

merger before the problems become a matter of concern for the authorities.<sup>1</sup> In the present crisis many banks have lurched into imminent insolvency more rapidly than the authorities expected. Traditional indicators of soundness based on capital adequacy have not proved sufficiently helpful.

However, this again is an instance where this was known in advance but had not been widely experienced in practice. As Peek and Rosengren (1996) argued, even in the US where there is a strong regime of Structured Early Intervention and Resolution (SEIR) in which prompt corrective action (PCA) is mandated under FDICIA within a timetable of increasingly harsh action as the problem worsens, what usually arouses the authorities' concerns is not capital adequacy but some other indicators or less formal information.

This presents a number of problems. The normal incentive for the troubled institution, its potential purchasers and the authorities is delay. The institution hopes that it can turn itself round, benefit from some good fortune or at worst get an attractive bid from a potential acquirer. Purchasers are worried on the one hand that there may be hidden problems and that further investigation is needed and on the other that it may be possible to get a better price, particularly if the public sector can be persuaded to underwrite some of the risks. Supervisors will also tend to delay first because some of the blame for a failure may be attributed to them and second because they do not want to be accused (and sued) for withdrawing the licence of what turns out to be a viable institution. Fannie Mae and Freddie Mac represent examples in the US where the problems were known but actions were insufficient.<sup>2</sup>

Hence any intervention points need to be unambiguous. All parties need to know that, when the point is reached, intervention will take place and they need to know what the intervention

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<sup>1</sup> Even when a purchaser for the entire bank cannot be found before failure an orderly transfer of much of the bank as in the case of the latest failure in the US, BankUnited, in mid-May 2009, is more common even if with a delay as in the case of Indy Mac.

<sup>2</sup> Not being banks Fannie and Freddie were not subject to the scrutiny of the larger supervisors - FDIC, the Federal Reserve of the OCC - but to the smaller OFHEO (since strengthened and merged into the FHFA in 2008).

will be, so they accept deals that offer better terms. However, many other triggers are likely to be less rigorous. Clearly it is possible to have strict limits on leverage and on liquidity requirements. It is also possible to make the capital requirements more sensitive to the economic cycle but even measures of risk under the Pillar 2 review in Basel 2 are likely to be rather softer in their application and make it relatively difficult to offer a clear ground for action as was needed for many of the UK banks, especially Northern Rock, Royal Bank of Scotland and HBOS, for example, and others such as Fortis in continental Europe. However in most jurisdictions both the trigger points and the actions required are not precisely stated leaving the expected outcome ambiguous. It is often argued that such ambiguity is constructive because banks will fear the worst but, as the crisis has demonstrated yet again, it is not, as bailouts are possible and banks hope for the best. The simplest example is that after the rescue of Bear Stearns most people were expecting a rescue for Lehman Brothers so the resolution of that ambiguity had major consequences.

Some of the problems can be addressed despite these difficulties. The first is to have a resolution agency whose job it is to minimise the cost of resolving banking problems. This will at least reduce the incentive problem, as that agency has the incentive to ensure that preventative measures are of a high standard, as it is exposed to the consequences of problems. The case of the CDIC in Canada is probably a better illustration than the FDIC in the US as it is not also a supervisor. The UK has also grasped this by putting the Bank of England and not the FSA in charge of resolution. However, in effect they have divided the responsibilities.

Rather than the somewhat complex structure of US SEIR,<sup>3</sup> the UK has distinguished three regimes:<sup>4</sup> a 'green' zone where banks are regulatorily compliant and not seen as a potential problem; an 'amber' zone where there is heightened surveillance because there may be a

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<sup>3</sup> More complex than its original formulation by Benston and Kaufman (1994).

<sup>4</sup> Banking Act 2009.

problem of continued survival and a 'red' zone where the resolution process has to be implemented. It is the FSA that decides on when a bank moves between zones and responsibility is only that of the Bank of England when the red zone is entered. In the US, Canada and Mexico, for example, the resolution agency has some responsibilities even in the green zone – it needs to be convinced that it could handle the failure of any institution it covers in a way that would minimise the cost. At the very least the resolution agency needs to start work as soon as the amber zone is entered, even if this turns out to be a false alarm or the troubled bank manages to resolve its problems.

### **The nature of insolvency regimes that can be run across borders**

The failure of the three main Icelandic banks and also that of Fortis has revealed the extent of the difficulties that can emerge with cross-border banks – not that this was a surprise, the Icelandic banks had already been identified as 'too big to save' (Sigurðsson, 2003).<sup>5</sup> The Icelandic authorities did not have the resources to handle the losses in foreign branches even up to the limits of their legal requirements. The host authorities did not in general have the powers to step in and act themselves. The UK had to use the Anti-Terrorism, Crime and Security Act 2001 to try to ring fence the assets of the Icelandic banks in its jurisdiction. Other countries used ad hoc but less controversial methods.<sup>6</sup> In effect the host country authorities have had to meet the claims of depositors within their countries even though it was not their responsibility.<sup>7</sup>

The clearest issue that has emerged from the crisis is the need for a special resolution regime for banks and indeed all financial institutions whose failure might have consequences for

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<sup>5</sup> What is surprising is that the authorities both in Iceland and where the banks had foreign operations were prepared to let such a non-credible arrangement continue.

<sup>6</sup> Jännäri (2009) offers a good summary of the Icelandic crisis and its causes.

<sup>7</sup> While such payments may technically be loans, Iceland is not likely to be in a position to repay them for a long time.

stability (SRR).<sup>8</sup> Several countries, when facing the prospect of a bank failure, have found that they could not intervene in the way that they wished in order to preserve stability. The UK had to rush through legislation to nationalise Northern Rock. Iceland had to pass legislation in a day in order to permit a takeover of its three main banks by the supervisory agency.<sup>9</sup> Even before the crisis took hold Sweden had had the embarrassment of not being able to close a small bank, Custodia, because the shareholders and others facing losses could challenge the authorities' decision on closure in the courts.<sup>10</sup>

For such a regime to work it needs to permit intervention by the authorities while the bank still has some value once it is clear that failure is imminent. They need a small range of techniques available for effecting a resolution. In the UK these are the ability to transfer operations and assets and liabilities to other banks; to form a bridge bank under the control of the authorities; or, if neither of these works, to nationalise the bank with the price determined independently. Such actions must not be contestable in the courts although of course parties must be able to contest that the fair price was not paid and there must be no break in the legal operation of the functions thought vital, so that close out clauses and other stops on the bank's activities are not triggered.

In a cross-border context the problem is much worse because the authorities in different countries, whose first responsibility is for stability in their own country and minimising losses in their own country, have to work together. Objectives are likely to conflict and as most legislation stands at present these authorities do not have the power to place the greater harm to another country in front of the consequences for their own. Eisenbeis and Kaufman (2008) set out the conflicts of interest and how they might be resolved.

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<sup>8</sup> The interim report by the BIS working group on cross border resolutions (BIS, 2008) identifies resolution tools, ring-fencing mechanisms and close-out procedures as three main items for focus.

<sup>9</sup> Summary legislation was also needed in Belgium to handle the Fortis case.

<sup>10</sup> The Fortis decision is still being challenged in the courts over six months after it was implemented.

Not only do the legal powers in intervention and the occasions when they can be used vary considerably across countries<sup>11</sup> but their ability to act in a practical sense is also impaired. In general, action on foreign branches is likely to be the responsibility of the home country while action on subsidiaries is that of the host country. However, such actions can only be taken on a foreign unit of a bank if it is separable in practice. This issue has been addressed by New Zealand, which requires that all foreign owned banks of systemic importance must not only operate as subsidiaries, with adequate local capitalisation, but that these subsidiaries must be capable of operating independently within the ‘value day’ (RBNZ, 2006).

While New Zealand is unusual in having addressed this problem, the arrangements have not been tried out in practice, fortunately, and many difficulties remain. It is normal before a failure for there to be transfers between subsidiary and parent as the parent fights to keep the group afloat. There may be supervisory lapses in one or other country that contribute to the failure. Some of the essential services provided by the parent may not be available despite the prior agreement. All such issues need to be worked through, along with the costs of the structures banks have to maintain to comply.<sup>12</sup>

### **The problem of deposit insurance**

All the OECD countries outside Australasia had deposit insurance in place before the present crisis and deposit insurance has been adopted by a steadily growing number of countries (Campbell et al., 2009). However, for many countries the system had remained untested. Problems with banks had usually been resolved without the need to call on the deposit insurance fund. The United States remained relatively unusual in having a steady stream of failures in which resolution involved either a payout by the fund or active intervention by the

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<sup>11</sup> CEBS (2009) has conducted a review of the major variety across the EU.

<sup>12</sup> At least Australia and New Zealand have addressed the issue. In the EU it is still an issue for the future and the otherwise comprehensive de Larosière Group Report (2009) sets it on one side.

insurer (the FDIC). Now the system has been more broadly tested and found wanting in many important regards including the following:

- (i) It is not possible to pay out depositors sufficiently rapidly that a run on the bank can be avoided
- (ii) Coinsurance does not work, either in the sense that depositors monitor banks or in the sense that such insurance stops a run on the bank
- (iii) Authorities round the world have taken the view that existing limits for insurance were too low
- (iv) Where deposit insurance limits vary across countries, transfers of deposits in a crisis towards institutions with higher limits can be destabilising
- (v) Some schemes are simply not credible in that they cannot meet the demands placed on them in the event of an important failure
- (vi) Financing schemes that neither involve an immediate ability to call on public funds nor have substantial ex ante funding are not credible
- (vii) Traditional deposit insurance works for relatively isolated cases of bank failure but wider crises require more general guarantees and actions to avoid bank closures

Most of these concerns are long-standing (Campbell et al, 2007) but remained of little interest to regulators while the safety net was not called upon. In Australia and New Zealand that call has still fortunately not been made and it therefore will remain debatable whether the arrangements they have in place for normal times will actually function in the way that a typical bank failure will not lead to a bank run and a more generalised crisis.

It was the Northern Rock case in September of 2007 that showed up the initial problems most clearly, as this resulted in the first retail bank run in the UK since Overend Gurney in 1866 (Mayes and Wood, 2008). Inadequacies in deposit insurance were not the only cause of the

run, with problems in the Lender of Last Resort and supervisory functions also contributing.<sup>13</sup>

In the event, the prospect of a disorderly closure meant that the authorities stepped in and nationalised Northern Rock, so the inadequacies of the deposit insurance scheme were not revealed in its practice.

The greatest disaster was however the failure of the three main Icelandic banks, Glitnir, Kaupthing and Landsbanki in October 2008. There the problem was simply that the Icelandic authorities did not have the resources for a full payout even with the help of IMF assistance.

In the EU, if banks operate in other member states through branches, it is the responsibility of the home country both to provide prudential supervision and deposit insurance. In a small country with large international banks this is not credible. The Swiss realised this many years previously (Hüpkes, 2003) and placed a monetary limit on a payout, irrespective of the size of the actual claim. What is so surprising is that others did not follow suit and that an obviously non-credible system was allowed to persist.

As forecast by Kaufman (2007), it is clear that in present circumstances depositors, even when they are fully protected, are not prepared to accept an interruption in their access to their accounts which is in any sense material. In the US this is interpreted as being a week and in more recent discussions the EU has talked about three working days although this has been subsequently softened. It is difficult to come up with any clear definition of what constitutes a material break but something of a matter of a few days sounds reasonable. In the proposals for New Zealand (Harrison et al., 2007) the implication was that depositors should regain access to at least much of their funds (after imposing a haircut to cover the loss) by the next working day.

Technologies have changed since deposit insurance was first instituted and it is no longer the case that banks are closed between some time on Friday afternoon and Monday morning,

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<sup>13</sup> The general run of problems is well summarized in the parliamentary enquiry (House of Commons, 2008) and the supervisory failings are also documented in the supervisor's (FSA) own investigation (FSA, 2008).

during which time the resolution can take place without having any impact on depositors (other than worry). Now with internet access people can try to withdraw much of their funds at any time of day or night, so a stop to normal transactions will have to be imposed unless the process of resolution involves the continuation of the existing business or the transfer of the business including all the computing systems and withdrawal systems to another provider. Any transfer of accounts to another provider is likely to take a long period of preparation. In the case of the failure of the Bradford and Bingley Building Society in the UK in 2008, the Bank of England found that it was possible to organise the transfer to another provider within a period of two months. Thus if a bank fails slowly, as is often the case and the authorities can be involved in the resolution at least two months in advance then a smooth process can be achieved. If the failure is rapid, there either has to be extensive pre-positioning so that the failing bank can identify who the insured depositors are and the extent of their insured deposits very rapidly or the resolution method has to involve continuation of the deposit taking business. This could be in the form of a bridge bank or even an assisted transfer and does not need to involve a bailout. The pre-positioning element would require extensive knowledge of the bank's computer systems by the deposit insurer and the resolution authority where they are not one and the same.<sup>14</sup> The deposit insurer also has to have access to the funds for a payout rapidly.

It is clear that systems of insurance and guarantees are linked across countries. Not only did Ireland's implementation of a blanket guarantee spread quickly to competitor countries but the implementation of a guarantee for the Swedish banks, which also applied to their operations in Latvia, led to a transfer on deposits away from the main domestic bank Parex on such a scale that a major rescue was needed and ultimately the country itself needed an IMF loan to survive the impact.

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<sup>14</sup> FDIC (2008) sets this out for large banks in the US.

## **Issues for Australasia**

The principal lesson is that other countries hit by the crisis found that systems they thought workable but were untested actually failed or underperformed in practice. Fortunately these safety net systems are untested in Australia and New Zealand. A thorough review in the light of overseas experience particularly in pre-positioning is a much cheaper way to improve them than to have a test in practice. Of the three areas highlighted in this article Australasia has made most progress on a viable regime for bank resolution but it is still not clear that it will be able to ring fence problems amicably or avoid the state support that has been endemic elsewhere. Finding new methods of credible early intervention applies just as strongly as elsewhere and having an SEIR where such intervention is mandated in a similar way in both countries would go a long way towards resolving the difficulties that might otherwise occur with the interaction of two regimes that are so different in philosophy.<sup>15</sup> However, the largest discrepancy lies in deposit insurance. Although subject has been carefully reviewed (Davis, 2004) and proposals put forward for a modest scheme in Australia, all other OECD countries have seen the need for schemes that would insure depositors up to around \$100,000 (AUD/NZD). Such schemes are intended to cope with orderly exit of financial institutions in the case of the rare failures that might occur and not a general financial crisis where ad hoc guarantees are the norm as at present to reassure people about the entire financial system. No doubt most people believe that major losses to ordinary electors will not be politically tolerable and that in the event people will be covered but the consequences of such insurance systems not working in the current crisis must be considerable food for thought.

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<sup>15</sup> With Australia applying a conventional intrusive regulation regime and New Zealand emphasizing the importance of disclosure and self and market discipline.

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