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WHO DECIDES? RESOLVING FAILED BANKS IN A EUROPEAN FRAMEWORK

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Highlights

- As the basis for a European regime for resolving failing and failed banks, the European Commission has proposed the Bank Resolution and Recovery Directive (BRRD) and a regulation establishing a European Single Resolution Mechanism (SRM) and a Single Bank Resolution Fund (SBRF). There is a debate about which parts of the proposed SRM-SBRF to add to the BRRD. The BRRD sets out a resolution toolkit that can be used by national resolution authorities. The SRM would involve European institutions more at the expense of national resolution authorities. This change could affect resolution outcomes.
- Domestic resolution authorities might be more generous than supranational authorities in providing assistance to banks. A supranational approach might be more effective in minimising costs for taxpayers. But regardless of the final design, more attention is needed to ensure that resolution authorities are politically independent from governments.
- When public support is provided to failed institutions it should come from a bank-funded resolution fund. This would reduce taxpayers' direct costs, and would make banks less likely to take risks and advocate for bailouts.

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THE FINANCIAL CRISIS HAS SPURRED the further development of a European banking union. After making progress on the first step – shared financial regulation under the European Central Bank's supervision for the larger banks – European decision-makers have focused on how to resolve financial crises. A fundamental problem is the ability of European governments to commit credibly to politically unpopular resolution measures. Before a crisis, a government can state that it will not hesitate to close insolvent banks. It can signal that the banks' shareholders, creditors and depositors over the guaranteed amount (€100,000 in European Union member states) will be bailed-in and bear losses. It can also indicate that it would replace management if the public sector is involved in the bank restructuring. These statements are reasonable attempts *ex ante* to minimise public costs and avoid moral hazard.

During a crisis, however, these commitments may not be credible. Imposing losses on shareholders, creditors and depositors could be politically unpopular. Furthermore, in systemic crises it might be difficult to impose loses on banks without needlessly destroying bank value. Announcing a bail-in of a bank's shareholders, creditors and large depositors could lead them to rapidly remove their funds from the bank. Bank runs worsen and hasten bank failures. Shareholders, creditors and large depositors at other banks might also withdraw their funds in anticipation that a bail-in of their own bank is on the way. This process is effectively what we saw during the Lehman Brothers collapse in 2008.

Formal bail-ins are only one tool proposed for European bank resolution. European Commission proposals also allow for separating troubled assets from a bank, transferring all or part of a troubled bank's business to a bridge institution and selling the bank. These tools can be used to impose costs on banks for their resolution, but generally do not lead to rapid bank runs. For example, asset separation is the acquiring of assets from a failing bank by a public institution at a certain price. These assets are then placed in a special purpose vehicle – a 'bad bank' – that manages and sells them. This aids resolution by injecting capital into the banks and removing difficult assets, allowing banks to focus on their core activities. Resolution costs are also imposed on banks[1] when assets are acquired at a price less than their original book value. Selling troubled banks and transferring part or all of a bank's business into a bridge bank that is then sold can also impose loses on shareholders and creditors depending on what support is given to the bank to restructure it before sale and what price it is sold for.

We argue that the consistency and effectiveness of these tools for imposing costs on banks in a European framework depends on which level of government takes decisions and how they are overseen. That is, to what extent are the relevant authorities national or supranational?

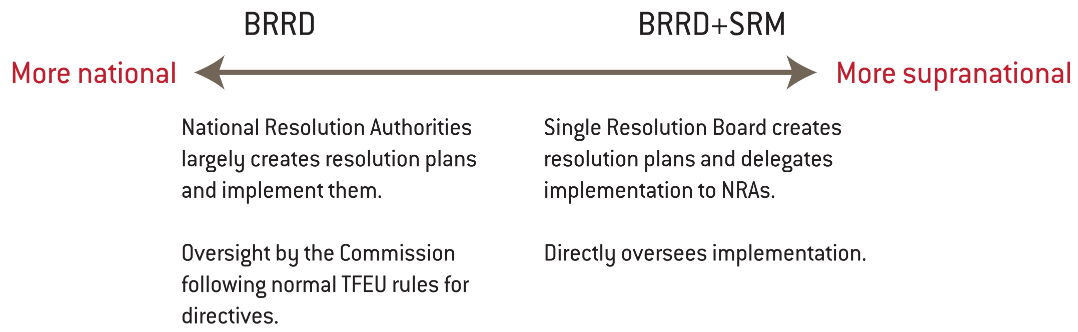
We first briefly lay out two highly contrasting possibilities for which level of government could plan resolution and oversee its implementation. The Commission proposed the Bank Resolution and Recovery Directive (BRRD, COM (2012) 0280) in June 2012[2] and a regulation establishing a European Single Resolution Mechanism (SRM)[3] and a Single Bank Resolution Fund (SBRF) in July 2013 (COM (2013) 0520). The BRRD without the European level represents an approach that relies the most on national authorities, while the BRRD plus a Single Resolution Mechanism represents the maximum participation of European institutions that has been proposed and is therefore the most supranational of the options currently on the table. (Figure 1). Though the actual system chosen probably will lie between these proposals, contrasting them helps us examine how the decision-making level will likely impact the ability to use the four

1. Asset separation effectively forces banks to write down the value of bad assets. In addition, costs are indirectly imposed on shareholders, for example, through lower earnings per share and possibly to creditors and large depositors if the bank needs to restructure their obligations due to having smaller funds available to meet them.

2. COM (2012) 0280, *Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms*, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0280:FIN:EN:HTML.

3. When we refer to the SRM we specifically mean COM (2013) 0520, *Proposal for a regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms*, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0520:FIN:EN:HTML.

Figure 1: Different possibilities for European asset separation decision-making and implementation



Source: Bruegel.

resolution tools to contain the costs of failed banks.

In the second section, we discuss the interests of national resolution authorities (NRAs) and the European institutions that will likely shape their behaviour. Both will likely have an interest in providing public assistance to troubled systemically important banks, but NRAs are more likely to have reasons to use resolution tools to bailout a wider group of banks with public funds rather than to impose costs on them. Though these problems will likely exist under any of the current proposals, the problems will likely be worse in a member state-led system. In the final part, we show that if the recent past is a guide, resolution authorities will have close ties to member state politicians who may have short-term incentives to undermine commitments to resolve banks in ways that impose losses on them rather than on the public. We argue that more attention should be paid to making national resolution authorities more politically independent from governments.

1 OVERVIEW OF THE COMMISSION'S PROPOSALS

Each of the Commission's proposals, the BRRD and the proposed regulation establishing the SRM, has guidelines on how to identify banks that are failing, and lays out who draws up the plan to deal with these banks, including what tools are available, who implements the plan, how it is funded and who oversees implementation. There are two key differences between the proposals, which have important implications for resolution outcomes: who decides which banks need to be resolved and how; and what happens if there is non-compliance with EU rules. We discuss each in turn. Table 1 on the next page presents a summary comparison of the two approaches.

Member state-driven resolution

The stated purpose of the BRRD is to harmonise bank resolution practices across Europe in a way that minimises costs for taxpayers while restoring banking stability. If implemented by itself without an SRM, this proposal directs all EU member states to create toolkits for dealing with failing banks, a resolution fund to finance the toolkits and a national resolution authority to determine when a bank is failing and how to deal with it. For example, it establishes asset separation as one of four resolution tools and lays out general guidelines for how it can be used so that it can only be used in combination with at least one of the other tools.

In the BRRD proposal, individual banks make so-called recovery plans – typically updated annually – that are to be activated if the bank runs into difficulty. These plans are approved by the bank's supervisor, either the national regulator or, for large and systemically important banks, the European Central Bank under the newly established Single Supervisory Mechanism (SSM). However, if the bank continues to have difficulty, member state supervisors determine it is failing or is likely to fail according to the BRRD's general guidelines. If this determination is made, then it will be put into resolution. The ECB will also likely be involved in the decision for the larger banks under its supervision. The NRA, using BRRD tools, complemented by recommendations from the European-level Systemic Risk Board and the European Banking Authority, then draws up a resolution plan. The European Commission must approve the

Table 1: Comparison of the initial and summer 2013 Commission proposals

	Which level decides which banks to resolve & how?	
	Original Commission proposal, summer 2012 (BRRD)	Commission proposal, summer 2013 (BRRD + SRM-SBRF)
Who creates a recovery plan to prevent the failure of a troubled bank?	Banks create their own plans which are approved by the relevant supervisor (either national or SSM).	Banks create their own plans which are approved by the relevant supervisor (either national or SSM).
Who initiates resolution of a failed bank?	Member States' supervisors based on rules set out in the BRRD.	Resolution Board based on information provided by the ECB and based on rules set out in the BRRD. The Commission approves the Resolution Board's decision.
Who creates the bank resolution plan?	NRA with recommendations from the Systemic Risk Board and European Banking Authority.	The Commission creates the general plan, with the Executive portion of the Resolution Board determining the specific plan. Both are guided by the BRRD toolkit.
Who creates cross-border resolution plans?	Resolution Colleges including the national resolution authorities and the EBA.	The Commission creates the general plan, with the Executive portion of the Resolution Board determining the specific plan. Both are guided by the BRRD toolkit.
Who implements the plan?	NRA	NRA
Who oversees the implementation?	Commission to the extent that the NRA's actions violate the BRRD.	Resolution Board
Sanctions for non-compliance with EU directives/plans?	Commission following the normal procedures as per the TFEU.	The Resolution Board can circumvent the National Resolution Authority and directly implement the part of the plan the NRA is not in compliance with.
How is the plan funded?	National Resolution Funds	Single Bank Resolution Fund

Source: Bruegel.

plan in line with state aid rules. The NRA is then responsible for implementing the plan. To the extent that upfront public financing is required, resolution will be paid for by a national resolution fund pre-funded by the country's banks.

The BRRD is a directive, which means it needs to be transposed into national law. Ultimately non-compliance with the BRRD would be identified by the Commission and sanctioned after adjudication by the European Union Court of Justice (ECJ) using the normal procedures laid out in the Treaty on the Functioning of the European Union (TFEU). Importantly, even though they would be bound by national laws resulting from European Union directives – particularly the BRRD and state aid rules – member state authorities drive the resolution process. They come up with the specific resolution plan and implement it.

European level-driven resolution

The Commission's proposal from summer 2013 is to have a regulation creating a Single Resolution Mechanism for euro-area members and any other member states that choose to join. For these countries this proposal subsumes the BRRD. It places the responsibility for identifying failing banks and planning their resolution at European level. It creates a Resolution Board that drives the resolution process. The Resolution Board will be composed of executive members[4], representatives from the Commission and the ECB, and representatives from the NRAs. However, the 'executive' section of the Resolution Board makes specific resolution plans. European-level officials and NRA representatives from the affected member state(s) comprise it. No member of the executive section has a veto over the resolution plan. The executive sec-

4. The executive and deputy executive directors will be proposed by the Commission, reviewed by the Parliament and approved by the Council.

5. Other organisations are involved in this stage of the process. The Board decides if a bank is or will become insolvent based on information provided by the supervisor, ie the European Central Bank. The Board also creates a resolution plan based on the broad resolution framework set out by the Commission.

BOX 1: CONTROVERSY OVER RESOLUTION FUNDING & IMPLICATIONS FOR RESOLUTION COSTS

The issue of how the resolution plans will be funded remains open. Though the focus of the Commission's proposals is to impose costs on bank shareholders, creditors and large depositors, it is recognised that it may not be feasible to cover all of the resolution costs this way, especially as immediate large bail-ins could cause bank runs and further instability. Public funding will be required at least in the short term to, for example, purchase assets from failing banks and place them in a public bad bank or provide liquidity to a bridge bank.

There are two points of contention regarding the structure of the resolution funds. The first is whether or not the funds will be managed at member state or European level. The second is their primary funding source: taxpayers or banks.

Similar to many countries' well established deposit insurance funds, the Commission's BRRD and BRRD + SRM proposals both call for resolution funds that are funded at the level of 1 percent of deposits at banks through contributions from banks themselves made both *ex ante* before a bank is resolved and rebuilt *ex post* by contributions made after a resolution. The key difference between the proposals is that in the BRRD-only plan, each member state sets up and administers its own resolution fund. There is the possibility of cross-borrowing between funds. In the BRRD + SRM plan, one fund is created for the entire banking union. It is referred to as the Single Bank Resolution Fund (SBRF). The medium-term costs of bank resolution would primarily be spread across banks either nationally in a BRRD-only system or across the whole SRM area under BRRD + SRM.

Another proposal that has been discussed, especially during the post-2013 election German coalition government negotiations, is whether or not to use the European Stability Mechanism (ESM) to fund the SRM. This would be similar to the current arrangement for dealing with banks that need support before a BRRD/SRM is created, especially as a result of the upcoming ECB-led stress tests. The ESM is capitalised by member state taxpayers. It issues bonds that it can use to recapitalise banks by providing loans to member-state governments, and once the SSM is fully established, banks directly. Medium-term costs incurred by the ESM fall on member-state taxpayers.

Some, including Irish finance minister Michael Noonan, have proposed a combination of the two. In a statement of 13 November 2013*, he argued that a single resolution fund should be created backstopped by the ESM, arguing that this was particularly important in the ten years before the SBRF is fully capitalised.

Using either a member state or European-level resolution fund that is *ex ante* and *ex post* funded by banks most directly protects taxpayers from resolution costs. Even if the ESM were used as an ultimate backstop for these funds, the costs to taxpayers would be lower because (a) bank *ex-ante* funds had already been used thus reducing the costs for the ESM and (b) presumably the system would be designed so that the ESM could recuperate much of its costs *ex post* from the bank-funded resolution funds.

The type of fund could shape not only taxpayer costs, but also total resolution costs by changing the incentives and politics behind resolution decisions. Relatively healthy banks that are not major creditors to troubled banks – and member states with healthy bank sectors – would likely oppose costly resolution plans that rely on bank-funded resolution funds. They know that they will have to make higher *ex-post* contributions to the funds. If a taxpayer funded ESM is used and the ESM suffers losses, the larger economies will bear the brunt of the costs. Moreover, even if the ESM does not incur losses, such a system will likely increase moral hazard more than in the case in which banks fund the system. In the latter case, banks might be more willing to police other banks, knowing that they will have to pay more into the fund if a given bank fails.

* Available at http://www.finance.gov.ie/viewdoc.asp?DocID=7898

tion would decide which bank or banks need to be resolved because they are or will become insolvent. It then sets out a resolution plan[5]. The plan will primarily be funded by a European Single Bank Resolution Fund (SBRF), that is pre-funded by bank contributions. An important limitation of the Resolution Board is that it cannot require member states to use national fiscal resources to support an institution in resolution. There is nonetheless concern that taxpayer resources[6] might be used, especially before the Single Bank Resolution Fund is fully up and running (see Box 1).

The Board does not directly implement this plan but delegates implementation to the relevant member state's NRA. The Resolution Board oversees the implementation.

Importantly, the SRM is a regulation and would take immediate effect once passed. This gives European institutions more power to oversee its implementation. In particular, the SRM empowers the Resolution Board to implement directly parts of the plan if it deems the NRA to be non-compliant. In this proposal, the European-level institutions drive the resolution process, but they still depend on member states to implement it.

2 COMPARING GOVERNANCE ISSUES

Three key differences between the two possibilities are: who sets out the resolution plan, how the plan is monitored and how public assistance is funded. In the European-led approach, the 'executive' section of the Resolution Board, with considerable input from the Commission, sets out the plan. It then delegates the implementation of the plan to the NRA. The SBRF provides the funding while the Board oversees compliance. In the member state-led approach, the NRA sets out the plan and implements it. They will rely on a national resolution fund.

To understand the implications of these scenarios, we need to know the interests of the relevant officials.

The interests of national resolution authorities

What are the interests of the NRAs? To answer this question, we first need to know who the national resolution authorities are and what mandate they have. In both of the current proposals, the NRAs are designated by member state governments. They could designate the central bank, a financial regulator, a deposit insurer, the ministry of finance, a specialised authority and so on. To avoid conflicts of interest, the current proposals require that the part of the agency involved in resolution be 'functionally separate' from the rest of the institution.

It is difficult to evaluate the efficacy of this requirement. How are the managers of the resolution authority appointed? By whom? What is the length of their tenure? All of these issues influence how independent the resolution authority is in practice. This is an especially tricky issue because unlike central banks or financial regulators the resolution authority will not have much to do during non-crisis times. As such, it will likely run with a skeleton staff for most of the time and then greatly expand during crises. The additional staff may be seconded from the main organisation, their future prospects still tied to performance as evaluated by the overarching institution. These are important issues because they influence the resolution authorities' goals.

An important consideration in previous work on bank policymaking is the closeness of politicians to banks (see Rosas, 2009; Satyanath, 2006). The simplest assumption is that banks would advocate less strenuous resolution procedures that would shift costs to banks. Politicians with cronyistic relationships with banks could then pressure NRAs to provide generous assistance to failing banks. All else being equal, even healthy banks might want less strenuous terms because they may be creditors to troubled banks. They would presumably wish to avoid being bailed-in. However, if support for bank resolution is provided by a bank-funded resolution fund, individual banks will have divided interests that could undermine efforts to mount a concerted lobbying effort. Failing banks and banks that are significant creditors of these banks would likely prefer bail-outs. Other banks, which contribute to the resolution fund but are healthy and not significant creditors, would likely prefer strenuous bail-in type resolution as they would effectively be paying for generous support through *ex-ante* and *ex-post* contributions

6. See for example *Wall Street Journal* (2013) 'Bank Resolution Funds Needs Poses Risks for National Budgets-EU Lawyers', 12 September, available at http://online.wsj.com/article/BT-CO-20130912-703692.html.

to the resolution fund. If a domestic fund is used, they would be even more opposed to generous support than if a European fund was used, because their contributions would be much larger.

Nonetheless there are at least two reasons why domestic politicians might wish to provide generous support to failing banks: electoral incentives and banking nationalism.

To win an election, a government will want the economy to be performing well, possibly facilitated by credit growth. Authorities that are politically dependent, such as ministries of finance, might have different incentives to independent authorities as elections near. They may be more inclined to boost their countries' banks, the banks' shareholders, creditors and depositors, and their economies in the short-term by, for example, hastily transferring toxic assets to bad banks at unrealistically high values. Though such a move would provide a boost to bank balance sheets and help stabilise the wider economy over the short term, it would also impose high longer-term costs on the resolution fund and possibly the public if the support exceeds the resolution fund's resources. Furthermore, even if a resolution fund is mostly financed through banking sector contributions and does not rely on direct taxpayer support, using it to provide unnecessary assistance to troubled banks will lead to an inefficient allocation of capital, indirectly hurting citizens by constraining longer-term economic growth.

The BRRD attempts to contain politically-motivated drift. In the case of asset separation, for example, it requires independent valuation of assets that are transferred to the bad bank. However, this rule is malleable. The independent valuation requirement can be waived in rapidly moving crises when many of the bank failures will occur. This gives NRAs room to make asset valuations that may please specific constituencies, but increase taxpayers' resolution costs.

A number of authors have suggested that national authorities in Europe have a 'banking nationalism' that inclines them to both want to support their domestic banks and prevent these banks from being acquired by foreign banks (eg Véron, 2013). An important reason for banking nationalism is that domestic banks are often a major purchaser of their member state government's bonds. Banking nationalism has clear implications not only for how stringently banks are bailed-in or the size of asset separation haircuts, but also choices about to whom a bank or bridge bank is sold. Domestic purchases might be favoured. For example, a domestic regulator might back a domestic purchase of a troubled bank for less than the bank might have received from a foreign purchaser.

The interests of the Resolution Board

What are the Resolution Board's goals? How closely are they aligned with the goals of the BRRD? In the absence of an actual Resolution Board to study, it is difficult to say definitively what their goals will be. However, we can make a number of educated guesses.

European banking lobby groups have already been important backers of European institutions' – including the ECB, Commission and European Parliament – policies (Epstein and Rhodes 2013, p4). However, it is unclear what the interests of European lobbying groups, such as the Association for Financial Markets in Europe, would be in relation to resolution decisions. Like for domestic lobbying, using a resolution fund based on banks' contributions would likely split banks' support for generous resolution programmes between troubled banks and their creditors on one hand and all other banks that contribute to the fund on the other.

Will the Resolution Board take action that is directly against what a national government publicly advocates, such as against the desired policy of a member state with a failed bank? If the member state insists it is in its national interest to bail out a bank, it may be difficult for the Resolu-

'The Bank Resolution and Recovery Directive attempts to contain politically-motivated drift. In the case of asset separation, for example, it requires independent valuation of assets that are transferred to the bad bank. However, this rule is malleable.'

tion Board to overrule it. It is also possible, however, that the Board faces pressure from other member states because 'their' banks stand to lose significant sums if they are the creditors that stand to be bailed in.

There are institutional reasons why lobbying by European banking associations and member states may not generally be the primary drivers of the Resolution Board's interests. As noted above, a permanent staff, the ECB and the Commission, and the NRA in question compose the Board. The permanent staff are meant to be technocrats who do not represent any particular member state. One assumption we might reasonably make is that given the dominance of the politically independent ECB and the international-level Commission in the Resolution Board's executive section in which the NRAs do not have a veto, and in which the European-level actors can outvote them, it is likely that the Board's interests will be relatively closely aligned with the goals of the BRRD. The ECB in particular is designed to ensure greater political independence when it fulfils its mandate, while the Commission should be insulated from the interests of shareholders, creditors and depositors of banks in any one member state.

There is another reason that less-stringent terms may be given to banks that are systemically important at European level. These banks are more important to the European financial system. Imposing, for example, tough bail-in conditions may cause bank runs from creditors, shareholders and large depositors at both the bank being resolved and its creditor banks. This could have significant implications for both financial stability and the supply of credit to the European economy. To avoid this situation, the Resolution Board may choose less-stringent resolution terms for banks that are systemically important at the European level. A useful comparison is with the United States, where small and medium-sized banks are regularly resolved by the Federal Deposit Insurance Corporation with costs generally imposed on banks. During the recent financial crisis, after policy-makers observed the consequences of bailing-in Lehman Brothers' creditors, the US government decided to commit taxpayers' money to substantial bank recapitalisations.

Possible outcomes from these interests and institutions

Under the most recent Commission proposal, which gives primacy to the European level, the Resolution Board can address issues of non-compliance primarily by circumventing national resolution authorities. If an NRA is non-compliant by, for example, overvaluing assets being transferred to a bad bank, then the Board can directly implement its policy to the extent that it can require banks being restructured to comply. The decision to do this will likely be made by the 'executive' portion of the Resolution Board. None of the Board members have a veto, including the NRA. It seems that if non-compliance is identified, corrective actions could be taken.

However, during a crisis and especially for the asset separation tool, it will be difficult to identify non-compliance. One of the main reasons for placing assets in a bad bank, rather than selling them, is that their value cannot be easily determined. During a crisis, there is a range of possible medium-term values that a troubled asset could have. The probability that the asset will have any one value in this range is very difficult to determine (see van Suntum and Ilgmann, 2013, p368), not least because this probability is conditional on the outcome of the resolution programme, which is itself uncertain. Due to this uncertainty, there is a great deal of discretion in the determination of asset values. National resolution authorities with incentives to, for example, impose lower costs on the banks despite medium to long-term public costs could easily choose higher values for the assets that they transfer to the bad bank, than would have been chosen by authorities with different incentives. One way to avoid this problem would be for the Resolution Board to set a flat or fairly flat haircut for all acquired assets. Though it is easier to observe deviations from a flat haircut, this is a very blunt tool that may lead to severe over- or under-valuations.

Though enforcing compliance with an asset transfer plan in the European-level approach will be difficult because of asset-value uncertainty, and will depend heavily on the Resolution Board's and NRAs' interests, compliance with the BRRD will likely be more uneven in a member state-led approach. In a system in which the NRAs both create and implement the resolution plan, the power to set the resolution agenda is in the hands of the NRAs. They may have many different goals, such as protecting important banking-sector constituents or improving the economy before an election. In the European-level approach, the NRAs could benefit from uncertain asset values to achieve their own goals. This is a relatively limited freedom of manoeuvre compared to the member state-led approach. Here the member states will likely have even more leeway to choose, for example, which assets to transfer and at what price, whether or not to use bail-ins and sales of the business. They will be constrained by the rules set out by the BRRD. However, enforcing these rules will be difficult and time consuming. It will involve the Commission first identifying a violation, sometimes a difficult task given, for instance, the uncertainty surrounding troubled asset values. Then there will be an ECJ adjudication process, rather than a simple vote of a Resolution Board.

By the time remedial action is applied it might be long after the crisis, and long after assets have been acquired at terms preferable to banks. The threat of a possible sanction in the longer-term might not dissuade a government that is worried about being re-elected or satisfying a political constituency in the short-term.

Even under a BRRD-only system, preferential sales to domestic purchasers might be difficult for NRAs. Outright discrimination against one purchaser compared to another – for example because of banking nationalism – is prohibited by the BRRD. And it seems that it would be more difficult to circumvent this rule compared to, for example, choosing high asset valuations when there is uncertainty about an asset's medium-term value. Selling a business is a more drawn out process than buying toxic assets. It would be more easily observed by European institutions. Perhaps, a more realistic scenario is one in which national resolution authorities choose not to pursue the sale of a business, though it may be cheaper for the resolution fund and taxpayer compared to asset separation, out of fear that a foreign buyer will present the most competitive bid.

Under the European-level approach the NRA will not be able to choose which tools are used; it can only influence their implementation. European-level authorities will likely not feel nationalistically towards a particular member state's banks. The opposite is probably more likely, in that the authorities want to promote European banking integration through cross-border mergers. Therefore, the problem of a resolution plan avoiding the sale of an institution, even if it is the best alternative for taxpayers, is less likely under a European-led system.

Perhaps the NRAs will be more cost conscious if they have to rely on national resolution funds, rather than an external euro-area resolution fund? There are problems with this assumption. It has proved difficult to commit not to guarantee implicitly euro-area governments during banking crises. This is because market actors have been worried about the effect of contagion from a euro-area country. Market concerns about contagion increased borrowing costs for other imperilled governments and even threatened the euro itself. In order to avoid contagion, it is possible – or at least member state governments could believe it is possible – that an exhausted national resolution fund would be supplemented by funds from other euro-area members, including borrowing from other member states' resolution funds and the already established ESM.

3 WHO ARE THE NATIONAL RESOLUTION AUTHORITIES LIKELY TO BE?

In both the European and member state-level resolution proposals, the credibility of plans to impose costs on failed banks and minimise taxpayers' expenses is highly dependent on the NRAs. Who are these institutions likely to be? To gain insight into the choices member states are likely to make, we examine the choices they made in the recent past.

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We conducted a survey of bank resolution in the European Union since the start of the global financial crisis until 2012. Following Sapir and Wolff (2013), our survey was based on the *Failed Bank Tracker* data set compiled by Open Economics. Table 2 provides a list of the EU countries in which we observed bank failures, national public institutions involved in resolution, and examples. In general, ministries of finance were likely to be involved in the resolution of larger banks. Of the 15 EU countries in the sample with bank failures, in more than three-quarters (12) there were instances of the member state's ministry of finance taking an important or leading role in bank resolution. In some cases, other bodies, such as financial regulators, appear to have taken the lead on resolution for banks that were small relative to the size of the member state's banking system. In particular, the now defunct Financial Services Authority took the lead in resolving many struggling smaller building societies in the United Kingdom. The UK Treasury was much more involved in the recovery and resolution of major banks, such as the Royal Bank of Scotland.

What does this suggest about who national resolution authorities are likely to be? If we simply assume that the current 'resolution authorities' will become the future NRAs, then it appears that a large proportion of member states will choose to place their NRAs either in, or closely associated with, their ministries of finance. If they choose to assign resolution duties *ex ante* to a different authority independent of finance ministries, such as an independent deposit insurer or a separate specialised authority, then this will mark a major shift in how banks are resolved in Europe.

A shift like this could certainly happen. Gandrud (2013) found that, since the 1990s both in Europe and globally, there has been a move away from ministry of finance involvement in financial supervision to more politically independent regulators. An important component of this process for many countries was strong promotion of independent supervision by international and regional groups. This suggests that the European Union, especially the Commission and the European Central Bank, could successfully promote the idea that NRAs should be independent of political authorities.

Table 2: Examples of failing or failed banks in the EU, and national public institutions involved in their resolution (2008-12)

Country	Key institutions included in resolution	Examples
Austria	Ministry of Finance	Hypo Alpe-Adria Bank International
Belgium	Ministry of Finance	Dexia, Fortis
Denmark	Central Bank, Special Resolution Authority (Finansiel Stabilitet)	Capinordic Bank, Fionia Bank
Finland	Financial Supervisor (FIN-FSA)	Sophia Bank
France	Ministry of Finance	Dexia
Germany	Ministry of Finance, Federal Financial Supervisory Authority (BaFin) (Current)	Hypo Real Estate
Greece	Central Bank, Hellenic Financial Stability Facility	TT Hellenic Postbank, National Bank of Greece
Ireland	Ministry for Finance, Central Bank	Anglo Irish, Irish Nationwide Building Society
Italy	Ministry of Finance, Central Bank	Delta, Bcc di Altavilla Silentina e Calabritto
Latvia	Ministry of Finance, Bank Supervisor	Parex bank, Latvijas Krajbanka
Lithuania	Ministry of Finance, Central Bank	Bankas Snoras AB
Netherlands	Ministry of Finance, Central Bank	Fortis, SNS REAAL
Portugal	Ministry of Finance, Central Bank	Caixa Geral de Depósitos, Banco Privado Português
Spain	Ministry of Finance, Central Bank, Special Resolution Authority (Fund for Orderly Bank Restructuring)	Bankia, Caja Sur
United Kingdom	Ministry of Finance, Central Bank, Financial Supervisor	Royal Bank of Scotland, Chelsea Building Society

Source: Bruegel based on the *Failed Bank Tracker* data set compiled by Open Economics. In total there were 88 banks in the survey from the European Union that were failing or failed. Note this includes banks that received public assistance and those that did not and were resolved in another way, usually through being acquired by another private institution. This is most likely not an exhaustive survey. Also, given the often rapid and complicated nature of bank failures, our data on national public institutions involved in resolution may be incomplete. It is also difficult to tell at this point each institution's relative decision-making importance in each case.

However, so far there has not been much public discussion of the topic. This is in contrast to the concerted effort to get member states to adopt independent fiscal councils.

What about during a major banking crisis? Just because an independent NRA is created before a crisis does not mean that the ministry of finance will not insert itself into the resolution process during a crisis. It may have strong political incentives to do so, while the scale of the crisis could mean that further public financing from the treasury is required. For instance, the involvement of finance ministries in many bank resolutions recently was not due to a pre-established resolution plan, but was borne out of political imperative, generally to avoid widespread bank failures by using some sort of publicly funded assistance. For example, the Dutch Ministry of Finance nationalised the Dutch operations of the large cross-border bank Fortis not as part of a pre-determined plan, but in order to prevent the deterioration of the economy that a collapse of the bank could have caused. There are many ways ministries could exert influence over NRAs during a crisis. One example given earlier is the provision of staff on secondment to the NRA, but with career advancement prospects tied to the ministry.

What does this suggest about likely governance problems under the two resolution proposals? Both proposals rely on national resolution authorities. If recent trends of active involvement of the finance ministry in resolution translates into NRAs being closely aligned with national finance ministries, then many NRAs will likely have incentives to pursue policies, such as over-valuing assets transferred to a bad bank, that may please a particular constituency, but which could lead to more costly resolution. If, on the other hand, strongly politically independent NRAs are created, politically motivated drift from the commitments set out in the BRRD may be less severe. Nonetheless, because it is up to the member states to decide who the NRAs are, there will likely be variation across Europe under both proposals. Some countries will create independent NRAs, while others will create more politically dependent ones.

Under the member state-led proposal, NRAs have considerable power to set the agenda as well as implementation power. It will be more difficult to address non-compliance with the BRRD. In the European-led proposal, the Resolution Board and Commission set the agenda and can more easily address non-compliance. The NRAs are relevant under both proposals, and there will be variation depending on the composition and independence of the institutions member states pick to be their NRAs. We expect more variation in how well NRAs resolve failed banks in a cost effective way under the national approach, than under the more supranational one.

4 CONCLUSION

Of the competing approaches to a European framework for recovery and resolution, a more supranational approach may lead to more consistently credible commitments to resolve bank failures at minimum public expense, especially when the asset separation tool is used. However, 'more consistent' certainly does not mean that the commitments' credibility will be equally strong across all bank types and situations. Failing banks that are systemically important to Europe will likely receive more generous public support when they are in trouble. Thus regulatory preventative measures are vital complements to any of the proposed resolution systems.

Also, regardless of the resolution system chosen when public support is provided to failed banks, it should be given from a bank-funded resolution fund. Such funds would reduce taxpayers' direct costs, and would also change banks' incentives to take risks that lead to bank failures and dampen advocacy for bailouts.

Under any of the current proposals, NRAs will play an important role. How well an individual member state commits to effective resolution will depend

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on whom they choose for their national resolution authority and what governance structure this institution has. If national resolution authorities are going to resolve failing banks, it is important that more effort is given to specifying who the NRAs are. At a minimum, this means that a framework for strongly independent NRAs should be developed and heavily promoted, especially by the Commission and the ECB. It would even be worth pursuing a stronger legal requirement for independent NRAs that share characteristics with fiscal councils. Note that fiscal councils do not set fiscal policy in European member states, but they do comment publicly on what course of action a given government is taking. In any resolution case that involves public money, one would expect that the finance ministry would be involved. Like an independent fiscal council, an independent NRA would be more likely to engage the public and to make such decisions in a way that is more transparent and more likely to protect taxpayers.

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