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Curtailing capture through the European banking union: a note of caution

Cornelia Woll[1]

June 2014

One of the motivations for establishing a European banking union was the desire to break the ties between national regulators and domestic financial institutions in order to prevent regulatory capture. The centralization of supervisory authority under the auspices of the European Central Bank aims to prevent conflicts of interest that can exist between national authorities and financial institutions operating in global markets. In particular, critics have pointed at regulatory leniency towards national champions, the protection and promotion of domestic regulatory standards at the disadvantage of foreign competitors or implicit encouragement to hold domestic sovereign bonds. One of the most glaring lessons of the recent crisis seems to be that elite failure – both on the side of the public authorities and the private sector – was the result of complacency, misjudgment and sometimes even outright manipulation that could have been avoided if supervision and regulation happened at a greater distance. By centralizing these functions at the European level, financial institutions will no longer be able to play their domestic advantage, or rely to the same extent on much criticized sources of proximity with regulators such as schooling and education, rotating doors or joint golf excursions.

Breaking up the intricate relationships between national authorities and their financial institutions will help to prevent dysfunctional complacency in the future, but it also contains risks. Frequent interactions between public and private actors not only allow circulating technical information, they also help constitute social relationships where both parties agree on rights and obligations that may go beyond formal rules. As a consequence, they can produce public benefits that would be imperiled in the current proposals for centralized supervision.

The aim of this policy letter is to detail such public benefits in order to counter discussions that focus only on conflicts of interest. It is informed by an analysis of how financial institutions interacted with policy-makers in the design of national bank rescue schemes in response to the banking crisis of 2008.[2] Using this

[1] Cornelia Woll is Professor of Political Science at Sciences Po Paris, where she directs the Max Planck Sciences Po Center on Coping with Instability in Market Societies since 2012, and the Interdisciplinary Center for the Evaluation of Public Policy, LIEPP (2011-2014). This note builds on the lecture "Power of collective inaction: Bank bail-outs in comparative perspectives", delivered in the Policy Center Lecture Series at the Research Center SAFE on May 15, 2014.

[2] The extensive study of crisis management in the United States, the United Kingdom, France,

information, it discusses the possible benefits of close cooperation between financial institutions and regulators and analyzes these in the wake of a European banking union.

1. The benefits of close ties

Identifying conflicts of interest in order to purify public action is a theme that runs through policy-making, the media and academia alike. Much of it is common sense. Numerous reports have highlighted how decision-makers have failed to grasp the urgency of the crisis because stakeholders that had an interest in continuing business-as-usual reassured them. Regulation prior to the crisis was in many times inadequate because regulators insufficiently questioned the self-assessment of the industry. Pointing to the ties between regulators, supervisors and the financial industry, many have insisted that capture is at the origin of these problems.

But the ties between public officials and industry representatives are social relations. They can be dysfunctional and lead to rent seeking, but they can also produce public benefits. Academic discussion has made very similar observations about social capital: it is at the base of criminal organizations such as the mafia but also constitutive of civic arrangements that help to promote economic development and democracy. It is thus important to distinguish between relationships that only serve particular private interests and those that provide public benefits. Since the discussion has excessively focused on mechanisms of regulatory capture, this note concentrates on the latter.

Organizing regular and collective consultations with decision-makers from the financial sector and public authorities has three advantages. First, it helps to discuss and evaluate a joint interpretation of common challenges. In combination with independent data gathering and supervision, interactive public-private feedback on the situation of individual financial institutions can give key insights into current evolutions and future challenges. The necessity to obtain such collective feedback becomes clear in the discussion of systemic risks. It is now widely accepted that not just the behavior of individual institutions matters for financial stability, but also the ways in which they are connected. Despite concerted efforts to find objective ways to measure systemic risk, regulators will always deal with an inter-subjective element that affects how systemic risk situations play out: the psychology of investors on financial markets. The subjective interpretation of individual financial institutions can thus supplement hard data on interconnectedness.

Second, collective private cooperation can help to limit public intervention in a crisis situation. Many governments sought to rely on private takeovers for distressed banks during the recent crisis and several aimed to encourage collective liquidation consortia. In essence, governments encouraged the financial sector to chip in to find a private solution for a failing competitor, as had been successfully experimented in

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response to the failure of Long-Term Capital Management in the United States in 1998. In response to the recent crisis, several governments negotiated with their financial industry to establish joint rescue schemes. In France and Austria, liquidity was provided through a public-private arrangement, which grouped collateral of private banks backed by a public guarantee in order to issue securities that helped to keep domestic banks afloat: the Société de financement de l'économie française (SFEF) and the Österreichische Clearingbank AG (OeCAG). In Denmark, the Danish banking industry established the Danish Contingency Association for the support of distressed banks, which gathered fees for a collective guarantee and acted as an intermediary to the government for deposit guarantees and recapitalization, leading to extensive burden-sharing between the government and the financial industry. In all three cases, the willingness of the financial sector to engage collectively in order to stabilize the economy in times of crisis arguably reduced the extent to which the governments needed to commit taxpayer money.

Third, collective discussion and cooperative arrangements create oversight mechanisms based on private sector knowledge that regulators cannot easily replace. The lack of detailed financial knowledge regulators had prior to and during the financial crisis has been repeatedly criticized. In one of the most extreme cases, a tape recording of senior executives at the failed Anglo-Irish bank reveals that the bank knowingly maneuvered the government into granting aid based on entirely imaginary numbers. While such strategies seem to have passed in bilateral business-government negotiations, they are harder to imagine in a collective setting. Market actors work under similar conditions and face comparable constraints. They are thus well-equipped to judge the situations of their competitors. In situations where collective arrangements imply costs to all participants, this oversight can help to limit the existence of the aid in time. To cite an example, all major French banks accepted recapitalization in 2008 in order to avoid stigmatizing distressed institutions. When the scheme was extended in 2009 for a second round of recapitalization, two banks left arguing that the initial objective of stabilizing the economy was no longer at stake. This decision signaled that recapitalization had become an issue for the private interests of some, no longer for the financial stability of the industry as a whole.

To summarize, in collective settings, close relations between the private sector and public authorities can create positive outcomes. They allow for the circulation of technical information and inter-subjective assessments, create the bedrock for public-private arrangements during times of crisis and enable collective oversight that can rely on industry expertise. As a result, they may produce publically supported intervention that is both cheaper and shorter than intervention designed and carried out by public authorities only.

2. Prerequisites

In advocating close interaction between the financial industry and public authorities, the tricky question is, of course, how to advocate cooperation in the public interest without encouraging ties that only serve private benefits. As mentioned above, one

key element is to structure public-private consultations as collective undertakings, not as bilateral relations. Financial institutions are necessarily concerned with their individual situation and will advance their point of view only in public discussions. The goal of collective public-private interactions is not to make them think in terms of public interest, but merely to signal how much the individual interests are tied to the collective well-being of the sector.

In addition, it is necessary to encourage and formalize work relationships during fair weather in order to be able to rely on them in moments of crisis. The Danish Contingency Association was established by Danish banks in 2007, but had previously existed as a public guarantee fond initiated in 1994. When the Danish Contingency Association was put to test with the failure of Roskilde Bank in 2008, it quickly became clear that the bank would deplete the capacity of the fund. But the existing structure of cooperation enabled the industry to negotiate a rescue scheme with public authorities that would allow for the unwinding of Roskilde Bank and provide a response to the crisis of the entire industry. In Ireland, a handbook written for financial crisis management was simply left in the drawers when the economy unraveled in the fall of 2008. The bureaucratic guidelines were judged too complicated for the severity of the situation. The comparison indicates that modes of cooperation are more useful than precise instructions for future situations that are by definition uncertain.

Finally, even the most tried cooperation mechanisms will fail when the interests of the participants diverge too much. To some degree, the success or failure can therefore be considered a fatality, since it depends on issues that may be unevenly spread: the size of individual institutions, the internationalization of their portfolios or their risk profile and exposure, for example. However, many of these elements are quite well understood and it is possible to organize consultation and cooperation mechanisms that take into account the homogeneity and heterogeneity of interests. Certain discussions will require a broad spread of representation, but others may be more helpfully dealt with in arenas that bring together only large commercial banks, investment funds, or saving banks, for example. However, it is necessary to break up sub-sections and integrate them into discussions that touch upon issues across the board, in order to avoid creating very entrenched sub-cultures in European finance.

3. The future of banking union

The challenge for European banking union is to transpose to the European level all the advantages of centralized supervision – and there are many – without destroying those parts of the social tissue at the domestic level that are actually working well. Although it might seem naïve or cynical to talk about corporate citizenship in the context of banking, it is important to communicate to the financial industry that they are not just the object of regulation. Financial institutions are also stakeholders in the economy that benefit from European arrangements and that have obligations beyond regulatory compliance. The European bank levy to support, *ex ante,* the resolution fund is a first and useful step in formalizing the idea that European

financial institutions are members of a community of fate.

In addition, European authorities should try to construct consultative fora that bring together decision-makers of financial institutions on a regular basis. These discussions should serve to supplement relationships between the industry and regulators that will continue to exist at the domestic level. Rather than delegitimizing domestic ties as sources of “banking nationalism”, European authorities should draw on their strength to create an integrated framework with building blocks of consultative subsidiarity. Such a framework will be especially critical for the success of the upcoming Single Resolution Mechanism. When push comes to shove, the resolution of a significant financial institution needs to be handled over a weekend. Despite their sophistication, “living wills” alone are likely to prove insufficient as guidelines for action for resolution authorities in Brussels. It would be a blessing if public officials could fall back on existing networks and mobilize information from the private sector across Europe in moments of such urgency. For one thing is undisputed in current regulatory discussions: at some point a major banking failure is bound to happen.