Resolving Cross-Border Banks: Lessons from the Nordic and European Banking Crises

Keynote speech at the Conference on Cross-Border Banking and Regulatory Reforms

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Good morning. I am honored to deliver a key note address today at this joint IMF/BCBS conference on the topic of Making Finance Work for Africa.

In the early 1990s, Sweden experienced a massive banking crisis. To make things worse, the Swedish economy was at the same time hit by a combined currency, macroeconomic and fiscal crisis. In those days, the cross-border element of the Swedish banking system was still very limited, except on the funding side, and the crisis was essentially home-made and domestic in nature.

As we all know, the financial sector has gone through considerable globalization and cross-border integration since then. This is true also for the Swedish banking system. In the mid-1990s, the remaining Swedish banks – restructured and revitalized after the crisis – began to expand their activities rather aggressively outside the Swedish borders, primarily in other Nordic and Baltic countries.

When the Global Financial Crisis hit the world with full force in 2008, Swedish banks had roughly half of their combined assets abroad and nearly half of their total profits came from business outside Sweden. In little more than a decade, the Swedish banking system roughly quadrupled in size compared to the early nineties, to somewhere in the region of four times the Swedish Gross Domestic Product when the global financial crisis broke out.

Of course, cross-border integration is not necessarily a bad thing. It is likely to enhance competition, and thus benefit households and enterprises with lower financing costs and a larger supply of financial services. This is something that tends to favor economic growth and well-fare in general.

However, as the Swedish banks expanded their activities abroad, it became increasingly evident that this cross-border integration would also pose a number of challenges to financial stability. In particular it could significantly complicate management of future financial crises.

Typically, financial crisis management requires the involvement of a number of authorities, such as central banks, supervisors, resolution agencies, deposit insurance agencies and finance ministries, depending somewhat on how financial stability work is organized and how responsibilities are distributed.

In general, coordination of the actions of these authorities is challenging enough in a purely domestic crisis. In a cross-border crisis, where you essentially have to multiply these authorities by the number of countries involved, the sheer quantity of authorities makes coordination very difficult.

Add to this any number of legal complications, such as confidentiality legislation that restricts information-sharing between authorities in different countries. Of course, also differences in language, culture, and, in particular, views on what or who deserves to be protected, can add further to all of these complications.

However, probably the greatest complication of all, is that conflicts of national interests could lead to political bargaining games that risk hi-jacking the resolution process altogether, or could lead to destructive ring-fencing that would crush any prospect of an overall beneficial outcome. I'll come back to this later.

Because of all these foreseen complications, Swedish authorities took several initiatives, from the early 2000s and onwards, to put in place arrangements, such as cross-border MoUs and various working groups, to enhance cross-border cooperation in the Nordic-Baltic region. In the fall of 2007, an extensive Nordic-Baltic crisis exercise was carried out, with participants from the central banks, supervisory authorities and finance ministries in the five Nordic countries and from the central banks in the Baltic countries, all-in-all eighteen authorities.

The cooperation efforts in the Nordic-Baltic region continues to develop to this day. A new MoU between authorities in the Nordic and Baltic countries was set up in 2010, and is now being revised again. And an MoU between the Central Banks in the Nordic and Baltic countries was signed as recently as in December 2016. A special forum – the Nordic-Baltic Stability Group – was formed in 2011 to address crisis management and other financial stability concerns and includes representatives from all relevant authorities in the Nordic-Baltic Region.

Under the umbrella of this group, a relatively detailed formula for sharing the financial burdens of a cross-border crisis, was developed. Some of these multilateral arrangements are now either being complemented or replaced by other arrangements as a result of the European Bank Recovery and Resolution Directive, which I will come back to later.

To be perfectly honest, a lot of the efforts to foster cooperation in the Nordic-Baltic region has so far not amounted to much in terms of *ex ante* binding agreements. MoUs of this kind are notoriously fuzzy, and are also often easily ignored. As a consequence, no burden-sharing discussions held among the Ministries of Finance involved have so far resulted in any <u>real</u> *ex ante* commitments.

Nevertheless, in my opinion, the efforts undertaken have great value in other respects. They have brought authorities in different countries together and made them more aware of the risks with cross-border banking. A shared terminology on financial stability concerns and challenges has developed, which makes it easier to talk about them. Valuable networks have been established, which has made personal contacts and communication swifter and easier. In my opinion, it was a great advantage to have had a lot of the crisis management discussions before the crisis, and we even had a chance to carry out a comprehensive crisis exercise before it erupted with full force.

As I touched upon earlier, conflicts of national interests can be particularly destructive. When taxpayers in one country risk ending up bailing out the citizens of another country, or when the citizens of one country perceives that they've been unfairly treated by others, bilateral relations can become tense. In the worst case, such things could stir up old wounds. During the global financial crisis we saw several examples of cross-border banking crises leading to some rather heated quarrels between countries.

Some of you probably remember the diplomatic dispute that arose after the failure of the large Icelandic banks in October 2008, when the Icelandic deposit insurance fund was unable to make good on its guarantees to over 300 000 primarily British and Dutch depositors, who had placed their savings in *IceSave*, a branch of the Icelandic bank *Landsbanki*. When attempts were made by the British government to freeze *Landsbanki's* assets in the UK using anti-terrorist legislation, massive demonstrations broke out in Reykjavik in protest of this.

Another example from the same period is *Fortis*. It was a then Belgium-based financial conglomerate, which had recently become a global player after having embarked on a joint acquisition of the Dutch mega bank *ABN AMRO*. After running into difficulties in financing its part of the *ABN AMRO* deal, *Fortis* was brutally broken up and divided along national lines among the Benelux countries. Feelings were upset in all camps, and the Dutch-Belgian relations were frosty for quite some time, as I recall it.

Of course, there have been many other instances where bilateral discussions have become heated as a result of crises involving cross-border banks. Admittedly, some difficult discussions also took place between Sweden and some of its Nordic and Baltic neighbors during the global financial crisis, regarding swap agreements and other matters. (During that period, Swedish authorities were very concerned about the Swedish banks' exposures in the Baltic countries and the risk of contagion back to the Swedish banking system. Ironically, today, the authorities in the Baltic countries have expressed similar concerns about the Swedish banks' domestic activities, in particular the rapid expansion of mortgage lending, and the risk of contagion back to the Baltic subsidiaries and branches.)

This is where I think the IMF deserves a lot of credit. Besides being able to bring its expertise, let alone its financial muscles, to the table, the Fund often also plays an important role as a neutral third party in such sensitive bilateral talks. It will typically be easier for an impartial technocratic body like the IMF to impose conditionality on a country than it would be for an individual country without being accused of catering to national interests. In the end it is probably better that any patriotic indignation is directed towards the IMF rather than towards a neighboring country.

The new resolution framework that is now being implemented on a large scale around the world – in Europe this is happening via the implementation of the Bank Recovery and Resolution Directive – is based on the premise that home and host countries largely can agree *ex ante* on how a failing cross-border bank would be resolved. Detailed resolution plans are being developed within the context of so-called resolution colleges. In principle, the new framework is supposed to ensure that banks can be resolved in an orderly way, without jeopardizing financial stability, at the same time as shareholders and unprotected creditors – rather than the taxpayers – will shoulder the losses. The key instrument that is meant to achieve this is the bail-in tool, which lets the unprotected creditors of a near-failing bank have their claims written down and/or converted into shares, after the original shareholders have been wiped out.

There is, however, still a lot of uncertainty surrounding bail-in. For example, there is still a lot of wavering regarding exactly what and whose instruments should be bailed-in. This is still a cause for some concern. The preparations for a bail-out of Monte dei Paschi and possibly other banks that are now taking place in Italy adds further to this uncertainty, in particular about the available policy choice between bail-in and the application of precautionary capital support by the state. Until the stage for bail-in has been more thoroughly prepared, the jury is still out on how it will be applied in practice, especially on a larger scale.

Some of the challenges I've discussed concerning cross-border banking can be greatly affected by changes in the way banking groups are organizing themselves. The Swedish Banking Group *Nordea*, which is on the Financial Stability Board's list of Global Systemically Important Banks, has recently (2 January) carried out a transformation from a subsidiary structure to a branch structure.

This means that large parts of Nordea's foreign banking operations, which were previously conducted via separate foreign subsidiaries, are now instead being conducted through branches of a Swedish company. Such a change gives Swedish authorities a much more pronounced responsibility for both supervision and crisis management regarding the company's operations abroad. One positive aspect of this is that some of the coordination problems I just discussed can be reduced, as the decision power over such things becomes more concentrated and less scattered among different authorities.

On the other hand, a cross-border branchification of this kind, will considerably increase the undertakings of the Home country, which in the case of Nordea happens to be the Kingdom of Sweden. Such undertakings include possible liquidity support from the Swedish Central Bank and potential public crisis management measures, such as precautionary capital injections, should such measures be deemed relevant. Notably, the Homeland's Central Bank may need to provide liquidity support – not only in its domestic currency – but also in foreign currencies, something which might prove challenging in some crisis scenarios (in particular if swap markets are dysfunctional at the time).

In my opinion, the branchification of a cross-border banking group should therefore be met with stricter requirements on the bank to maintain liquidity buffers in *all* relevant currencies. The expanded undertaking should also trigger a discussion about the relevant size and composition of the Central Bank's foreign exchange reserves, and a discussion about possible swap agreements among central banks.

A branchification also implies an extended responsibility for the Home country's supervisor to include also supervision of the bank's foreign activities. It is therefore important that the supervisor is granted the proper resources to fulfil this greater task.

Finally, let me share with you some of the general lessons I’ve learned over the years, dealing with various crises around the world.

Lesson 1: A hole in the balance sheet never goes away just because you choose to ignore it. Someone always has to fill it, whether it be bailed-in creditors or someone else.

Lesson 2: Restoring confidence is key. Eliminating suspicions about any remaining losses lurking under the surface is crucial in this respect. It takes a great deal of determination to provide credible valuations, and above all, transparency about what you are doing. Valuation efforts that do not seem serious or simply too optimistic are counterproductive. They send the signal that you are either in denial or trying to hide something. Markets hate this kind of uncertainty, and will only postpone the recovery.

Lesson 3: Act quickly. It is typically better to just rip off the band-aid than to let problems drag on, allowing them to accumulate.

Lesson 4: Functions, not stakeholders, are the important thing. Upholding critical functions is the main goal, not protecting the wealth of bankers or others.

Lesson 5: If state support is still necessary in the end, make sure taxpayers get an upside. Don’t just socialize the losses.

In summary, *Lesson 6*: Go out and get the lemons, squeeze them, and start to plant new ones!

Thank you!