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## A stability and resolution fund for a robust financial market

The political debate about the lessons to be learned from the financial crisis has a central theme: who should assume the financial burden of systemic risk facing not only banks, but also the state and taxpayers? There is now a general consensus on the need to look forward. A special levy on the financial sector to pay for the current crisis would be unacceptable for several reasons. Since it has been agreed that state aid – from the German Financial Market Stabilisation Fund (SoFFin), for instance – will be repaid, such a levy would not least lack economic justification and raise constitutional concerns. The questions at issue are therefore how to keep the cost of systemic crises to an absolute minimum and how to involve the financial sector in bearing this cost in a fair and appropriate way. Plans are already on the drawing board in some countries. And at the end of March 2010, the German government unveiled the key points of its strategy, which includes a levy on banks for the purpose of building up a new stability fund. This levy now needs to be integrated into an efficient crisis management framework

### 1. Advantages and limitations of a stability and resolution fund

If designed correctly, the stability fund will go a long way towards making financial markets more resilient to crises.

- It should collect financial resources which can be used in the event of a systemic crisis to stabilise the entire market by strengthening the capital base of financial institutions or enabling them to be wound down with minimum market disruption.

## A brief word



One lesson to be learned from the financial crisis is that we must be better prepared in future. A stability fund organised along the lines recently agreed by the German cabinet can make an important contribution to a more stable financial order.

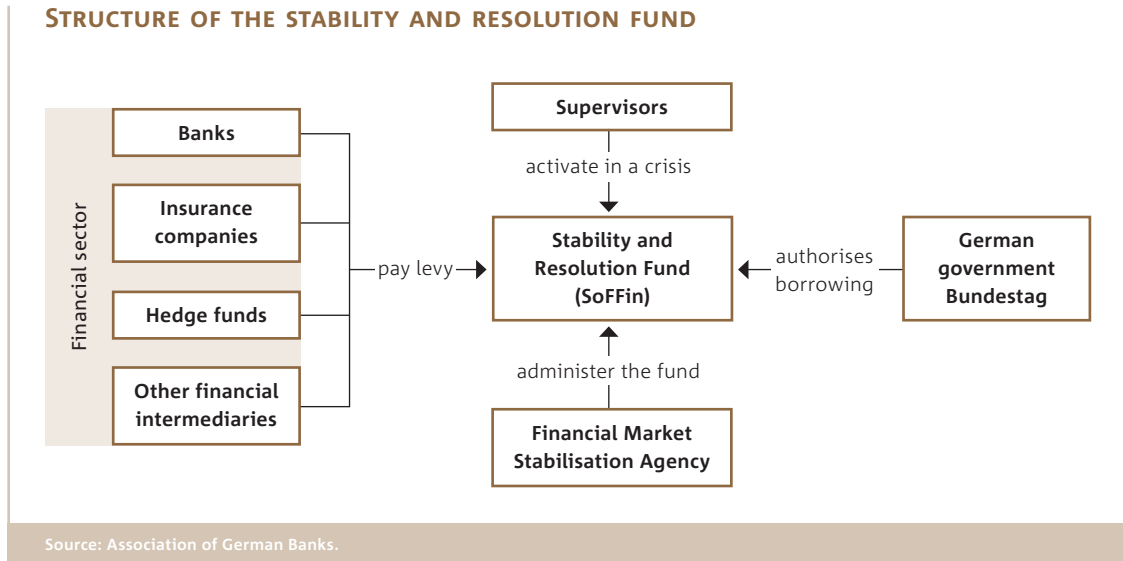
Drawing the right lessons from the financial crisis also means looking forward, not back. It is impossible to predict what will trigger the next systemic crisis or how that crisis will unfold. So everyone who will benefit from a more stable financial system should help to make this system a reality. All banks will benefit, be they large or small, private or public. But insurance companies will benefit too, as will hedge funds and other financial intermediaries. They should all pay their share – with contributions graduated according to the level of risk associated with their business.

Given the intensity with which the German government's strategy is being discussed, one further point also needs to be stressed: a stability fund is not a stand-alone instrument. Appropriate regulation and better supervision of the financial markets are and will remain the first line of defence against systemic risk. This means that the efficiency of the financial system as a whole needs to be ensured. The stability fund and the burden – particularly on banks – resulting from additional financial regulation must fit into an overarching framework.

A handwritten signature in black ink, appearing to read 'Manfred Weber', written in a cursive style.

Manfred Weber  
Chief Executive

- By building up a financial reserve to fund intervention measures and by clarifying regulatory and antitrust issues in advance, uncoordinated emergency responses can be avoided and action can be taken at as early a stage as possible.
- The fund can act as a buffer to prevent the state and taxpayers having to step in on an ad hoc basis to help stabilise the financial market. If a systemic crisis occurs, the entire financial sector will automatically shoulder part of the cost.
- Institutions which give rise to systemic crises but have previously been deemed “too big to fail” or “too interconnected to fail” will be able to go into insolvency without triggering massive disruption to the market.
- Intervention needed to restructure or wind up a financial sector company should be kept to a minimum. Responsibility will continue to lie first and foremost with the company's owners, followed by its creditors and the financial industry as a whole. This sequence will not cease to apply after the introduction of the stability fund. On no account should a company's owners benefit from measures taken in the public interest.
- Thanks to the financial resources at its disposal, the stability fund will be able to relieve the pressure on the state to act as a crisis manager. But a fund financed by market participants cannot be expected to take on all the responsibilities incumbent on the state in the event of a systemic crisis. The fund's resources will inevitably be limited. The state's ultimate responsibility for solving systemic crises cannot be removed by a stability fund.



## 2. Cornerstones of a stability and resolution fund

### Who should contribute?

The German government's plan envisages that the levy for the stability fund will be paid by the banking industry; other financial sector companies will not be involved. This is not the right way forward. The fund will enhance financial market stability. All market participants will benefit – this includes insurance companies, hedge funds and other financial intermediaries. It is extremely difficult, not only in practice, to draw a line separating companies that are systemically important from those that are not. A legal dividing line would be constantly shifting in response to the evolution of individual companies and the market and would thus ultimately be untenable. It would also have unwelcome ramifications. An institution's categorisation as "systemically important" because it paid the levy would send out a signal that it would enjoy particular state protection if it got into difficulties while companies excluded from the levy would not. This would have an adverse effect on the perception of the risk carried by such companies and on their refinancing costs.

These considerations were behind the decision to give the Financial Market Stabilisation Fund Act<sup>1)</sup>, passed at the height of the crisis in 2008, a broad scope of application. The levy should have the

same scope. It goes without saying that contributions should be graduated according to the level of risk posed. This would also set a further incentive to limit risk, improve risk management and promote greater financial market stability.

### Financing the fund – what level of resources is needed?

The size of the fund should be based on the need generated by possible crises. Amounts of between 1% and 5% of the gross national product are currently being proposed. In Germany, this would translate into between €25 billion and €120 billion. It should be borne in mind, however, that the experience of the recent crisis can only provide a rough guide to future needs. Better regulation of the financial markets in the form of higher capital requirements, for example, will reduce the risk of a future crisis arising in the first place. The level of resources needed by the fund is therefore likely to be at the lower end of the spectrum. A further argument in favour of comparatively modest resources is that the fund will only be one element

1) Under Section 2(1) of the Act, "financial sector enterprises" comprise banks within the meaning of section 1(b) of the German Banking Act, insurance undertakings and pension funds within the meaning of section 1(1) nos 1 and 2 of the Insurance Supervision Act, investment companies within the meaning of the Investment Act and operators of stock exchanges and futures exchanges and their respective parent enterprises if these are financial holding companies, mixed financial holding companies, insurance holding companies or mixed insurance companies and provided that the above enterprises are domiciled in Germany.

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of the future financial regulation regime. Another important aspect of this new regime is that, if a company gets into difficulties, supervisors will be able to initiate a restructuring procedure at an earlier stage.

The levy should not, moreover, place excessive strain on a company's ability to perform. Particular attention should be paid to the implications for its attractiveness in the capital market and – in the case of banks – its lending capacity. It will benefit no one if the financial sector is so weakened that it can no longer fulfil its role of financing the economy.

A starting point for the fund could be the German Financial Market Stabilisation Agency (Bundesanstalt für Finanzmarktstabilisierung – FMSA), which currently administers SoFFin. The agency is authorised to raise loans of up to €80 billion for the purpose of financing stabilisation measures. Levies from financial sector companies would flow into a fund administered by the FMSA and could gradually replace financing by the state. This would mean that the fund had a critical mass of available resources right from the outset.

### **A national or international solution?**

Given the level of integration in the internal market for financial services, a European solution would be preferable in principle. But this would entail an extensive transfer of power from national to European level, such as rights of intervention for an EU supervisory authority, and require a harmonised administrative and enforcement regime. There would also be implications for national fiscal sovereignty, a firmly entrenched feature of the European Union. Key prerequisites for a European solution are therefore not met and will remain unmet in the near future. So an EU fund is not a realistic option as things stand, making it essential to establish a network of national funds in Europe and among

### **The key task: to establish an integrated network of national solutions**

If each state develops its own solution without regard for a binding international framework, this will open the door to regulatory arbitrage. A worst case scenario would see market participants acting tactically if difficulties appeared imminent and exploiting different characteristics of different funds to their own advantage. Comparatively wealthy funds or funds with low access thresholds might find themselves disproportionately targeted. A greater will to ensure stability would thus ultimately be penalised.

Two points are essential: national funds must be set up on the basis of the same criteria and serve the same objective. On top of this, principles for international crisis management need to be agreed without delay.

- Binding, uniform criteria for calculating levies should be agreed at G20 and EU level.
- The same applies to determining which companies will be required to pay the levy and will thus have access to stabilisation funds.
- The levy paid by a financial sector company operating across borders should be based on its domestic assets only.
- It must be ensured that the amounts raised are not used for different purposes. If some countries set up a fund while others used the levy to help finance their budget, the resources available for crisis management in the event of a crisis would differ enormously.
- Standardised rules should also apply to the routine operation of the funds (e.g. investment criteria) and to procedures if a crisis occurs. Who will decide the criteria for activating the fund? How will coordination with national deposit guarantee schemes and public authorities in other countries function?

the G20. This is also the approach followed by the German government in its strategy paper.

It is nevertheless essential, in view of the close ties between financial markets, that this safety regime composed of individual national solutions will also be able to function in the event of a cross-border crisis. A national solution should therefore not be equated with a go-it-alone approach. The German government is called on to integrate the German stability fund into other European and international initiatives in an appropriate manner.