Foreign Bank Participation and Fiscal Burden Sharing in Cross Border Banking Crises. An Assessment for Eastern European Countries

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- Non-technical Summary -

The research paper explores ex-ante mechanisms for fiscal burden sharing to overcome the coordination failure in Eastern European Countries, where foreign banks control more than 65 percent of total banking assets. The framework examined in the project consists in assessing the impact of fiscal burden sharing in cross-border banking crises for Central and Eastern European(CEE) countries, and analyzing the policy implications for the case when a bank is systemic in the host country, but not in the home country. The mechanisms of fiscal burden sharing imply potential adverse selection and moral hazard problems; therefore the appropriate burden-sharing mechanism for the Eastern European Countries is a mix of ex-ante mechanisms.

The global financial crisis which began in August 2007 indicates the importance of effective cross-border crisis management and ex-ante arrangements. The absence of a multinational framework for sharing the fiscal burdens for such crises or insolvencies is, along with the fact that legal systems and the fiscal responsibility are national, a basic reason for the predominance of the territorial approach in resolving banking crises and insolvencies. In the context of the debate regarding the establishing of ex-ante mechanisms for bank resolution it is essential for CEE countries to assess the volatility of bank assets in these countries. Thus, the research paper estimates the unobserved value of assets as well as the volatility for five major listed banks in CEE countries.

Another analysis highlights how option pricing techniques help at developing an analytical formula for the premium a bank should pay to a hypothetical recapitalization fund whose purpose is to recapitalize a failing bank to allow wounding down in an orderly manner and in a timeframe that avoids the "fire sale" of assets. The magnitude of such a premium is analyzed using five major CEE banks.

The findings illustrate that:

- there was a sharp increase in volatility at the beginning of 2009, but as of mid 2011 it is converging back to pre-crisis values;
- the premium for a fund that provides recapitalization in order to allow the orderly failure of a bank in financial distress can be computed as the difference between the prices of two European put options.

The need to reduce moral hazard and build up financial buffers against possible future crises involves the development of a new policy framework. Although, at the beginning of crisis the ex-ante burden-sharing mechanisms were consistently rejected by the authorities and even the suggestion of a compartmented fund to which countries would all contribute without exercising joint responsibility fell on deaf ears, the G-20 leaders recognize that the financial sector should make a fair and substantial contribution towards paying for any burdens associated with possible government interventions or fund resolution.

Keywords: *banking crises, burden-sharing, ex-ante mechanisms, assets volatility, option pricing theory, deposits guarantee fund, resolution fund*