

Chicago Fed Letter

Global banking and national regulation: A conference summary

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Although banking across national borders has expanded rapidly, banking regulation remains nationally based. As a result, governments and financial institutions face significant challenges when instability arises. At the Chicago Fed's International Banking Conference, participants explored cross-border banking issues and ways to improve the current system.

Materials presented at the conference are available at www.chicagofed.org/InternationalBankingConference.

As financial consolidation and international trade have continued to expand in recent years, so too has cross-border banking: International banks based in one (home) country are becoming more deeply embedded in the banking activities of other (host) countries. However, supervision and regulation of these institutions remain, for the most part, nationally based. This can create problems when international banks experience financial difficulties. On October 5–6, 2006, the Federal Reserve Bank of Chicago, in conjunction with the International Association of Deposit Insurers, held its ninth annual International Banking Conference, titled “International Financial Instability: Global Banking and National Regulation.” The conference brought together academics, policymakers, regulators, and bankers from more than 40 countries to explore these issues and to discuss how they might be addressed *before* a crisis event occurs.

International banking and financial crises

The first speaker, Dirk Schoenmaker, Ministry of Finance, Netherlands, discussed the degree of bank internationalization in the Americas, Europe, and the Asia-Pacific region. He divided commercial bank activity into three categories based on where it takes place: the home country, the greater region, or the rest of the world. He found that European

banks are substantially less domestically concentrated than are North American and Asia-Pacific banks. Asia-Pacific banks were the most domestically focused, with some 86% of their business derived from home. Despite internationalization in banking, Schoenmaker concluded that very few banks could actually be considered “global” rather than national or regional.

Carl-Johan Lindgren, formerly with the International Monetary Fund (IMF), gave an overview of past cross-border banking and financial crises. He said he was surprised to find that among nearly 200 financial crises over the past 30 years, very few could actually be classified as “cross-border”—that is, national financial crises that were substantial enough to cause crises elsewhere. Moreover, the five cases he did identify, including Mexico in 1994 and Asia in 1997, primarily evolved from unsustainable macroeconomic policies, and they spread because of shifts in *perceptions* about stability in the countries rather than direct contagion through the banking system.

Central banks have begun to analyze financial stability in their own countries in an increasingly public way, according to Sander Oosterloo, Ministry of Finance, Netherlands. The number of central banks publishing financial stability reviews has increased sharply in the

last decade, with the goals of promoting financial stability, increasing transparency, and strengthening interagency cooperation. However, Oosterloo's research did not find a relationship between this transparency and actual financial stability.

highlight some key points: There has been dramatic growth in the number of hedge funds in recent years; the average hedge fund has increased in size; and about 50% of hedge fund assets are categorized as "global" or scattered around

even if complete mutual reliance is unlikely, he said. For example, a host country should feel comfortable relying on a home country supervisor when a firm has relatively low impact in the host nation. On the other hand, the home and host may want to focus more on collaboration rather than reliance in cases where the firm has a high impact in the host country. The ultimate barrier to mutual reliance and trust, he said, is political appetite: When a firm fails, the regulator must be willing to justify to elected leaders the decision to rely on another country's supervisory capabilities.

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Cross-border instability

Bent Vale, Bank of Norway, offered insight into the links through which cross-border banking instability might spread. He noted that these "contagion links" were mostly hypothetical, since crises transmitted directly through banking channels have been few. Vale distinguished between crises taking root in an international bank with a branch structure (one legal entity headquartered in a home country) versus a subsidiary structure (different legal entities in different countries). For example, problems in a parent bank in one country might lead to curbs on its lending activity. In a branch structure, these curbs might be systemwide, causing the problem to spread to other countries, whereas with a subsidiary structure, the lending curbs would be chiefly confined to the parent, reducing potential contagion.

Jon Danielsson, London School of Economics, discussed cross-border currency crises. He described the results of preliminary research into the relevance of trading volume to these crises. For one, he noted that currency trading volumes in different countries generally tend to move together, but this relationship weakens during a crisis. Moreover, countries that are close together do not necessarily show volume moves together, providing evidence of speculative trading.

Triphon Phumiwasana, Milken Institute, summarized data on hedge funds that he and his colleagues have collected in order to probe funds' roles in global financial risk. Data on the industry are hard to come by, making risk assessments difficult, but Phumiwasana was able to

the world. Also, he emphasized that hedge funds do not necessarily "hedge," but rather pursue diverse high-risk strategies with the goal of high returns. Unfortunately, gauges of their performance are incomplete, since funds come and go frequently and leave a limited data trail.

Supervision across borders

Richard Herring, University of Pennsylvania, guided conference participants through the tangled history of international banking supervision. The basic desire to ensure cross-border financial stability and to level the playing field between countries led to the first effort to coordinate supervision, the Basel Concordat of 1975. While the accord was an important step in terms of coordination and communication, persistent gaps fueled additional agreements through the years, eventually leading to today's Basel II principles. According to Herring, thanks to "enormous" efforts to harmonize different countries' regulatory frameworks, there has been significant convergence in core concepts. The task today, however, is to hammer out and organize actual rules.

Paul Wright, Financial Services Authority, United Kingdom, spoke about nonbank supervision across borders. After all, as the IMF's Raghuram Rajan noted in his luncheon speech, a tremendous amount of financial sector value (and risk) exists outside the banking system. Wright enumerated some of the risks that broker-dealers, reinsurance firms, and hedge funds pose to financial stability. As all of these entities are global in scope, they demand collaboration between authorities,

In prepared keynote remarks delivered in absentia, Stefan Ingves, Bank of Sweden, offered a summary of the overall challenges that cross-border supervision and regulation face. First, information sharing is difficult, particularly if a bank concentrates certain functions in certain countries. Second, conflicts of interest abound. Third, supervisors' assessments of the issues may be colored by national interests. Finally, simply coordinating decisions is problematic, since in a crisis, information is limited and actions must be swift. To begin coping with these challenges in Europe, Ingves suggested that a pan-European body should be established to help supervise major cross-border banks and lay a foundation for a European authority.

The government safety net

A key issue in cross-border banking regulation has to do with who takes responsibility when transnational banks run into trouble. What country or entity should provide liquidity in a time of crisis—in other words, who should function as a lender of last resort (LOLR)? Also, where can depositors turn when international banks fail? Vitor Gaspar, Bank of Portugal, argued that in Europe, the basic operational framework of monetary policy already provides an effective automatic LOLR structure. He contended that the European Central Bank's (ECB) marginal lending facility, which provides a ceiling interest rate for unlimited borrowing from the ECB, satisfies the principles of the classical LOLR doctrine. For one, the facility clearly supports overall systemic stability and monetary policy objectives.

In addition, it helps banks absorb liquidity shocks but requires good collateral and lends at “penalty” rates. Finally, the rules governing the marginal lending facility are well understood. As a result, Gaspar asserted that emergency assistance to individual institutions is unlikely to be an important issue in practice, despite provisions that allow for it.

Michael Krimminger, Federal Deposit Insurance Corporation (FDIC), noted that issues of cross-border deposit insurance rarely matter until a crisis occurs. When an international bank runs into trouble, the patchwork of national insolvency laws is ill-equipped to restructure the institution and continue critical payments in a reasonable time frame. Various national deposit insurance programs differ in the types of accounts that are covered, maximum limits of coverage, funding mechanisms, government guarantees, and payment speed. Perhaps most importantly, the flexibility of the laws varies, meaning that regulators often bypass the system during a crisis and bail out the institution with government funds. This creates issues of moral hazard with potentially significant economic costs. To deal with future crises, Krimminger urged deposit insurers to map out comparisons between programs. With global deposit insurance an unlikely scenario at this point, regulators should focus on understanding the areas of conflict and the opportunities for cooperation between their national programs. Separately, FDIC Chairman Sheila Bair echoed this sentiment in her keynote remarks, encouraging the sharing of expertise between deposit insurance bodies, so that crisis management can proceed more smoothly and efficiently.

Many presenters highlighted a thorny asymmetry that results from cross-border banking: An international bank branch or subsidiary may be relatively large for the host country, but small for the parent bank and home country supervisor, and vice versa. Andrew Powell, Inter-American Development Bank, and Giovanni Majnoni, World Bank, argued that it might be useful to think of an international bank in terms of a fully guaranteed “core,” which survives or fails as one, and a “periphery,” for which the

bank limits its responsibility to the capital it has invested. They conceptualized the solvency of the bank in terms of a portfolio of forward contracts (the core), which can produce profits or losses, and call options (the periphery), in which losses are limited. Powell and Majnoni concluded that with locally based deposit insurance, international banks have an incentive to relegate riskier subsidiaries’ activities to the periphery—that is, to limit the parents’ guarantees—and devote minimal capital to them. Unfortunately for the host country, this implies that the international parent would walk away from the subsidiary in a crisis situation, but Powell asserted that host deposit insurers can play a role in shifting this balance because of their power to set rates.

Insolvency resolution

Although the causes of cross-border banking and financial crises are not yet fully known, the negative effects are clear. Liquidity problems, settlement and clearing issues, and disruptions to hedge contracts are only a few of the difficulties that can result from these situations. Robert Eisenbeis, Federal Reserve Bank of Atlanta, argued that regulatory structures can actually add to the negative externalities. Specifically, Eisenbeis focused on bankruptcy laws. The longer the bankruptcy process, the longer depositors have to wait for access to funds, and potentially the deeper the crisis. This state of affairs is compounded in cross-border scenarios in which bankruptcy laws differ between countries. Eisenbeis contended that regulators should focus on instituting and streamlining bank-specific bankruptcy laws to limit the duration of credit and liquidity problems.

Rosa Maria Lastra, University of London, also lamented the lack of coherence in bank insolvency regimes. Like Eisenbeis, she voiced support for a bank-specific insolvency regime instead of European-style schemes in which banks are treated like other corporations. Because banks play a unique role in the economy and bank crisis management involves unique instruments (e.g., deposit insurance and the LOLR), banks remain “special,” Lastra contended. Nonetheless, she did not advocate the creation of an international

authority or world bankruptcy court. Instead, Lastra argued for a more fully defined set of common international rules and procedures. These rules might not have the force of formal law, she admitted, but they could facilitate mutual trust across borders, which is critical for greater harmonization and efficiency.

David Mayes, Bank of Finland, discussed some of the issues involved when a systemically important institution fails. Specifically, he enumerated a set of requirements for effectively managing the failure of such an entity. First, the authorities must be able to act quickly based on a predetermined trigger event. Next, the institution’s resources should be allocated in a way that respects the hierarchy that would have prevailed in an insolvency proceeding, but without contributing to moral hazard. Finally, the regime needs to ensure equitable treatment of all institutions. Mayes proposed that only a separate agency, not responsible for keeping banks open, should handle systemic bank problems. However, the legal framework for this necessary intervention does not exist in many countries.

Early intervention

Larry Wall, Federal Reserve Bank of Atlanta, outlined the notion of “prompt

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corrective action” (PCA), a system adopted in the U.S. that is designed to minimize deposit insurance losses by mandating early supervisory intervention at troubled banks. Lawmakers and regulators must accept a few key concepts in order for PCA to be effective, he said. For one, limits must be placed on supervisors’ discretion; unless they are *required* to act early, supervisors may wait out problems and hope they correct themselves. Also, it must be accepted that banks will be closed even at positive levels of regulatory capital. Wall then described the institutional requirements for effective PCA: supervisory independence, but with accountability; adequate supervisory powers, such as the ability to withdraw licenses; sound resolution procedures that inspire confidence; and reasonable, timely financial information. With these measures in place, PCA can help minimize the economic and financial costs of bank insolvency. However, most countries have a long way to go to meet the conditions necessary for an effective PCA strategy domestically, let alone in cross-border situations.

For his part, Arnoud Boot, University of Amsterdam, asserted that implementing a PCA regime in Europe, though difficult, might bring even more benefits than it has in the U.S. Today, the European system relies on national authorities for supervision and LOLR functions. Early intervention could forestall the more intractable coordination

problems and conflicts of interest that arise once a crisis occurs. However, Boot cautioned that adopting a PCA regime for banks may not be enough, since bank deposits are less crucial for accessing liquidity in today’s financial system.

Crisis prevention

The current cross-border supervisory framework—multinational banks with national supervision, and partial cross-border harmonization with persistent national differences—would likely run into trouble in a crisis. According to David Hoelscher, IMF, this makes it unsustainable. In order to prevent contagion, he argued that the system will likely evolve in one of two ways. First, there might be significantly greater harmonization of laws and regulations. Unfortunately, while the desire exists, the political will to pursue this goal is rather limited. Instead, Hoelscher believes that host countries will assert increasingly aggressive control over foreign branches and subsidiaries, as has been the case in New Zealand and Mexico. Although multilateral and bilateral regimes can try to contain this trend over time, host countries have powerful incentives to protect their own interests and exert more control today.

David Mengle, International Swaps and Derivatives Association (ISDA), summarized efforts made by private organizations such as his own to ensure

cross-border financial stability. In addition to more formalized arrangements, including the 1993 Group of 30 report, which helped institutionalize risk-management practices, the private sector also pursues day-to-day practices that implicitly promote stability. For example, ISDA has constructed a flexible master agreement for derivative transactions that is widely used. Such standardization promotes market liquidity and legal certainty, which in turn contribute to preventing crises.

The road ahead

J. P. Sabourin, International Association of Deposit Insurers, concluded the conference with a discussion of priorities for cross-border regulation going forward. First, he reminded participants that much work remains to be done at the national level. Safety net players within countries—deposit insurers, bank supervisors, and central banks—need to improve their communication before cooperation can extend across borders. Second, supervisors in different countries need to agree to and *adhere* to standards of minimum regulatory capital before an international system of PCA can take hold. Finally, Sabourin repeated the sentiment that substantive improvement of the system requires the political will to act. He urged all conference participants to help build that political momentum—before a crisis does it for them.