SPEECH

DATE: 2007-08-21
SPEAKER: Governor Stefan Ingves
LOCALITY: Conference on Financial System: Structure and Resilience
Reserve Bank of Australia, Sydney

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

Regulatory challenges of cross-border banking: Possible ways forward

Introduction

As the integration of financial markets has picked up speed in recent years the subjects of supervision and crisis management of internationally active banks have gained in importance. I myself have on several occasions argued that policy actions are needed in order to cope with the challenges arising from financial integration. Today, I will elaborate on one of my ideas, namely the creation of a special body for supervision of the major cross-border banks in Europe. For the sake of this speech let us name this body the European Organisation for Financial Supervision (EOFS).

Lessons from the past

Before elaborating on my proposal let me start by noting that financial and banking crises can be costly. From history we know that the economic and political crisis costs can be very large. The US depression and the hyperinflation in Germany during the 1930s are clear examples. After the Second World War, the conclusion was that the financial sector had to be heavily regulated. This gave the national authorities a certain control over the risks in the different national financial sectors, but at the same time regulation stifles competition, product development, efficiency and proper risk management. Eventually, these inefficiencies became large and apparent and many countries started deregulating in the 1970s and 1980s. In my country we have painful experiences of a banking crisis that occurred partly because the new deregulated environment posed new challenges for banks as well as for regulators; challenges they were not prepared for.

Eventually banks developed more appropriate risk management techniques and supervisors adopted a more risk- and process-oriented form of supervision rather than the previous rather formalistic type. This has clearly lowered the risk of financial crises.

SVERIGES RIKSBANK

Internationalisation of banking

Also after the deregulation, most banks have remained predominantly national. Only in the last decade have we seen the emergence of some big cross-border banks with major activities in several countries. And this financial integration is accelerating. Let me here be perfectly clear. This development is positive for the economy. It stimulates competition and product development across countries. It also means that the banks can profit from economies of scale and scope. The spread of cross-border banking has reached different levels in different parts of the world. In Europe it has been increasing rapidly in the last few years, but there are also several active cross-border banking groups here in the Pacific region.

This integration is not without challenges. In particular supervision and crisis management arrangements have to be addressed hopefully with some foresight, before we get another crisis. To explain this allow me to draw a parallel to the perhaps most burning issue in contemporary debate; the problem of global warming and climate change. The challenges of financial integration share some of the same characteristics as the environmental problems facing us. There are in short negative externalities.

As you all know, the impact of industry emissions on the environment is the classic example of what we economists call negative externalities. If the market is left without any intervention at all, the costs for the pollution will be borne by others than those who have actually been directly involved in the polluting business. The same reasoning can be applied to financial crises. A crisis that severely affects the functioning of the financial system will cause substantial costs to the entire economy, ultimately in the form of loss of output. These costs go far beyond what the financial firms can possibly take – or are willing to take – into account when conducting their day to day business activities.

Both with regard to pollution and financial crises there are ways to manage the negative externalities. Public interventions can be used so that the negative externalities are internalised in a way acceptable to society as a whole. For industries polluting the environment, authorities can for example impose taxes or issue emission rights to compensate for the social cost of pollution. For banks and financial firms this is achieved by regulatory and supervisory measures, such as capital requirements and rules for the establishment and conduct of business as well as provisions giving central banks the right to grant emergency liquidity assistance.

Many stakeholders, but no single authority

If the negative externalities are limited to a national scale, sufficient public intervention may be possible. National authorities have – or could be given – sufficient power to act. When environmental pollution crosses national borders, containing the negative externalities becomes more difficult, since the national authorities only have national mandates. Then some kind of supranational organisation or some form of cross-border agreement may be required. Similarly, in the financial area, as long as the externalities are limited to one nation, the domestic authorities can – at least potentially – be used to internalise the problems.

Thus, when banks start becoming important in several countries, there will be a mismatch between the potential problems and the roles of financial supervisors

and regulators. In the prevailing regulatory structures there are very few arrangements for supervision and crisis management designed for managing externalities with cross-border impact. Given that the financial markets get more and more integrated the lack of adequate cross-border regulatory structures creates a number of challenges.

Challenges

One challenge is that the interdependence between different countries increases. Problems in the banking system in one country are more likely to spill over to the other countries where the bank or group is active. The cross-border contagion effects are likely to be larger as banks are actively involved in several countries. This can be illustrated by one of the largest banks in my country, Nordea. It has substantial activities in four of the Nordic countries, and is also a significant part of the financial system in all these countries. Any serious problem in Nordea will therefore most likely affect all four countries.

Another challenge is that decisions and actions by national authorities are likely to have considerable implications for the financial stability in foreign economies. This is of course particularly true in cases where foreign operations are run through branches, meaning that they are subject to foreign supervision. However, in Europe at least, the consolidating supervisor has an increased influence also on foreign subsidiaries, within the new capital regulation – the Basel II-framework. In the Nordea case – which is now a group with a subsidiary structure – the Swedish consolidating supervisor has a possibility to influence the risk management of the group as a whole but also in the different subsidiaries. Now, Nordea has announced plans to convert its subsidiaries in the Nordic countries into branches. When, and if, this plan eventually becomes a reality, Swedish authorities will have the full responsibility for supervising three foreign branches, all of which may be of systemic importance in the different host countries.

A third challenge is that the legal distinction between branches and subsidiaries is becoming blurred. Increasingly banking groups are starting to organize themselves along business lines rather than along legal and national lines, concentrating various functions to different centres of competence. There are several examples of this trend. Again Nordea is one illustrative example. In order to reap the benefits from economies of scale and scope, Nordea has chosen to concentrate its different functions, such as treasury operations, credit decision-making and risk management to specific centres of competence within the group. It is therefore questionable whether the different entities within the group really are self-contained, even if they are legally independent subsidiaries. With this structure, it is also less likely that the group as whole can survive a failure of one of its entities. Hence, operationally and in economic terms, Nordea increasingly resembles a bank with a branch structure. A consequence is that the present regulatory structure may be less well-suited for efficient supervision and regulation of the group.

A fourth challenge is that the practicalities of supervision and crisis management are greatly complicated as the number of relevant authorities increases. In normal times, this means that the regulatory burden for the financial firms increases. Also, the need for supervisory cooperation increases, which demands new supervisory procedures and the creation of common supervisory cultures. In times

of financial crises, sharing information and coordinating action becomes a difficult priority, especially since time is a scarce resource in crises.

A fifth challenge is that conflicting national interests emerge as banks become truly cross-border. The national authorities have a national mandate and are responsible to the national government or parliament. They are therefore unlikely to take the full external effect of their actions in other countries into account. Different countries may also have different priorities in terms of resources for supervision and crisis management or in terms of their regulatory structures. One reason may be that the financial systems differ quite significantly between countries. Additionally, in crisis management, the use of public funds can never be completely ruled out. In a cross-border context, serious conflicts of interest can arise when it comes to agreeing on how to share the potential burden of such interventions.

All these challenges have a common theme. Increasingly, national financial stability is becoming dependent on the activities of banks and authorities in foreign countries. Also, given the roles and responsibilities of these authorities, conflicts of interest are likely to occur. The typical illustration of this problem is a bank being of limited size in the home country while having a systemically important branch abroad. While a potential failure of the bank would not create any substantial disturbance in the home-country economy the consequences to the host country could be destructive. As the host country, in the event of failure, is likely to end up with the bulk of the bill for resolving the crisis, the incentives to conduct close supervision of the bank are substantial. For the home-country on other hand the same incentives do not exist.

Financial integration also raises a number of practical issues. Do the present legal frameworks provide authorities with the necessary tools for supervising cross-border banking groups in an efficient way? And do the authorities themselves have arrangements in place to produce comprehensive assessments of the operations and the risks of these groups? Under the prevailing regulatory structures I am afraid that the answers to both of these questions are likely to be no.

Policy actions are needed

As I have tried to illustrate so far, financial integration gives rise to several challenges related to the supervision of cross-border banks. Most importantly, I have argued that the present supervisory arrangements are not designed to prevent the cross-border externalities that financial crises may result in. This, of course, is a growing problem in an integrated world. Furthermore, I have argued that there are deficiencies in how the supervision of internationally active banks works in practice, which can partly be explained by limitations in legislation and partly by supervisors not being sufficiently coordinated.

In my opinion all this gives us good reasons to reflect on how to take actions for revising the present regulatory frameworks. We need to find ways for countries to cooperate closely and establish mechanisms for coordination and conflict resolution.

Motives for a coordinated financial supervision

Most of what I have said so far is probably pretty uncontroversial both in terms of the analysis of the challenges of integration and of the need for action. However, it may be more difficult to reach agreement on how to move forward. A number of alternative solutions have been brought into the debate. For example, proposals such as prohibiting foreign branches from doing business domestically or extending home-country responsibility have been discussed.

My take on this, as I said in the beginning, is instead to gradually move towards the creation of a common international body with a mandate to conduct supervision of banks with substantial cross-border activities. The simple rationale is that the creation of such a body is the only way to fully manage the conflicting national interests. Also, such a body would have several other benefits. A single authority supervising cross-border banking groups instead of several would most certainly increase the comprehensiveness and the effectiveness of the supervision. For the firms subject to supervision, it could mean that the regulatory burden would eventually be reduced considerably.

In a European context, the idea of a European Organisation for Financial Supervision (EOFS) may at a first glance seem overly idealistic, and to be honest, in some respects it is. One can argue that it would be virtually impossible to make countries give up parts of their sovereignty to a supranational authority. However, looking at this from a European perspective, there is hope. Within the European Union there is already a framework for supervisory and regulatory cooperation, based on the common legislative process in the form of EEC-directives and regulations. Moreover some institutional arrangements for supervisory cooperation are in place, even if they do not have any legal powers. It may therefore be easier to reach some progress in Europe than elsewhere in the world. Still, even in Europe, it is not very likely that a full fledged Pan-European supervisor can be established in the near future. Therefore, my proposal should be seen as a gradual process rather than a fast-track to a European FSA.

Institutional set-up and powers of EOFS

Let me now go into more detail on how the EOFS would work. As I said earlier, the mandate of the EOFS would be to perform a form of supervision of the major cross-border banks at the European level. As the focus is strictly on prudential supervision, the supervisory tasks related to market conduct and consumer protection would still rest with national supervisors.

Aligned with the EU-principle of subsidiarity the supervisory duties of the EOFS should only include the banks with major cross-border activities. What I have in mind is a three layered structure. The 8000 or so European banks which mainly operate domestically would remain under the exclusive competence of national authorities. The regionally oriented banks, active in a few countries, could use a structure similar to that of today, where supervisory colleges deepen the cross-border cooperation. The limited number of truly Pan-European banks would on the other hand be dealt with by the EOFS.

In the first step the tasks for the EOFS, would in my view, be threefold: Firstly, it should gather information about the cross-border active groups. Secondly, with the information acquired, unified risk-assessments should be produced for the

banks subject to EOFS supervision. The third and final task should be to oversee the activities and risks of these banking groups.

To set up the EOFS one would, to start with, need to second staff from national supervisors and central banks. Initially the EOFS should probably only have limited powers, namely to collect information and undertake on-sight inspections together with national supervisors. All other powers, such as licensing activities, regulations, interventions and corrective actions would still remain the responsibility of national supervisors. Consequently, the EOFS would act alongside the national authorities producing comprehensive risk analysis of the designated banking groups and based on those analysis give advice on policy actions to the national authorities. In the event of conflicting interests between authorities the EOFS could also act as neutral mediator.

Further, a coordinated European supervision of banks and groups with significant cross-border activities would facilitate a more efficient management and resolution of cross-border crises. It would be easier to reach a common assessment of the systemic importance as well as the solvency of the bank or group in question.

What I, in content, am proposing is that the EOFS in its embryonic stage would function more like a non-regulatory central bank than a traditional supervisor. The EOFS would conduct macro-prudential oversight and act as an enlightened speaking partner to the supervisory authorities.

In my view, it is important that the EOFS is a separate agency with an independent status. The reason is that in order to be successful the EOFS would need a high level of operational independency and integrity. It is also important to achieve a necessary division of power. The EOFS should cooperate closely with other organisations but should still be free from direct guidance and involvement from national authorities as well as from the European Commission and the ECB. In my opinion, it should be given the same independent status as the ECB has today. With many other Pan-European regulatory bodies already in existence, it should not be too hard to come up with suggested proper financing arrangements.

If successful in its initial role, the tasks of the EOFS can gradually be extended by assuming additional supervisory powers for the truly cross-border banks. It would however first have to prove its merits.

As long as the EOFS operates in addition to the national authorities another layer of supervision is added to the present structure. From an industry perspective this would imply a greater regulatory burden. However, I believe – and hope – that it is something that authorities and banks can live with if the supervision as such improves and if the proposal increases the chances of a substantially lower regulatory burden in the future.

People acquainted with the present regulatory and institutional set-up within the EU may ask if what I am proposing is not already in place, considering the existing consolidated supervisory model and the role of the Committee of European Banking Supervisors (CEBS). However, even if both of these functions have their obvious merits they do not quite satisfy the needs. The CEBS mandate is to promote harmonisation of regulatory frameworks and not to conduct ordinary supervisory work. And even if the consolidated supervisor has group responsibility it is an undeniable fact that the authority answers to the home-land

constituents. Thus, the EOFS would contribute important functions in addition to the present regulatory structure within the EU. What I have in mind is an institution with real resources and not a "talk shop" primarily designed to build consensus.

Conclusions

Let me summarise. During the last decade, the banking sector has increasingly become cross-border. We should welcome this rather new form of financial integration as it enhances competition and stimulates economic growth. This development also raises challenges for the regulatory community. Our answer to these challenges should not be increased protectionism. Instead, we need to find new forms for cooperation and supervision that allow the benefits from integration to be realised. Today I have presented to you my thoughts on the need for a special body with the mission to supervise the major European cross-border banks. Since this proposal to some probably seem rather radical and not very conceivable in the shorter term, I have advocated a gradual approach. In my view, the time has now come to set up the modalities for achieving this goal.

The reason why I have chosen a European focus is simply that there are already institutional arrangements in place which can be used as a platform for bringing us closer to the goal of supra-national supervisory frameworks. In my view though, the underlying challenges of financial integration are of a global nature. Therefore, even if it may not be possible to achieve the same solutions outside Europe, it should be of wider international interest to at least move in the direction of enhanced cooperation between supervisory authorities. I hope that I have been saying here today can serve as inspiration for further discussions on this issue.

Considering that financial integration is already widespread and that the process of revising present regulatory structures will most certainly be demanding and protracted, we need to get to work. Returning to what I said in the beginning, history shows us the importance of having proper regulatory structures in place. Therefore, it would be highly unfortunate if the appropriate measures have not been taken before the next major financial crisis occurs. For once, it would be encouraging to see pre-emptive policy actions rather than a crisis being the catalyst for such actions.

Thus, in the same way as the international community is facing increasing challenges to cope with the negative externalities in the environmental area, the financial regulators have to face the consequences of financial integration. It is my hope that we as regulators show enough courage and determination to tackle the negative externalities a potential financial crisis would entail – before it hits us.

Let me finish by saying that the issue of financial integration comprises many more aspects than merely how to set-up supervisory structures for cross-border banks. For example, questions on how to establish proper arrangements for emergency liquidity assistance and deposit guarantee schemes also need to be considered within the same context. And even if these issues are of a somewhat different nature I believe that they do require the same type of supranational considerations I have talked about here. The simple reason is that it is only when the frameworks for regulation, supervision and crisis management match the

actual structure of financial markets, that the negative externalities of financial crises can be managed properly.

Thank you