Cross-border banking – regulating according to risk

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Following 2008: Lots of regulatory reforms

- Basel 3:
  - Higher quantity and quality of capital and liquid assets
  - Additional capital buffers for SIFIs
  - Macro-pru regulation
- Bonus restrictions
- Regulation of OTC markets
- On-going discussion on taxation
- …
The missing element - resolution

- Failure is part of market process
- Minimizing external costs vs. enforcing market discipline
- Dynamic feature: today’s behavior by authorities will influence tomorrow’s behavior by banks
- Expectations are important
- 2008 crisis has been addressed with ad-hoc and transitional arrangements; need for longer-term resolutions framework
The externalities of bank failure

- Network problem
- Hostage problem
  - Depositors panic
  - Contagion through payment system
- Fridge problem
  - Destruction of lending relationship, soft information
- Try to resolve swiftly
- Financial safety net
  - Supervision
  - Lender of last resort
  - Deposit insurance
  - **Bank resolution**
- Opposing objectives
  - Minimize risk of contagion and protect small depositors
  - Reduce moral hazard risk
Bank resolution – a basic framework

Minimizing externalities

Bail-out
Open bank assistance

Resolution possibilities frontier

Liquidation

Market Discipline
Bank resolution – an efficient framework

Minimizing externalities

Bail-out
Open bank assistance

Bridge bank

Purchase & acquisition

Merger & acquisition

Partial pay-out

Liquidation

Market Discipline
Why regulate cross-border banking?

- Failure of cross-border bank imposes costs on foreign stakeholders that are not taken into account by home country supervisor (Beck, Todorov and Wagner, 2013)
- Contagion effects through common asset exposures, fire sale externalities, informational contagion, interbank exposures etc.
  - Does not depend on direct cross-border engagements by banks and — on bank-level – not even on direct exposures to international markets
  - More prominently as banks move towards market finance
- Within-in monetary union: additional externalities
  - Close link between monetary and financial stability
  - Lack of exchange rate tool exacerbates impact of asymmetric shock
  - Common lender of last resort leads to tragedy of commons problem
- Regulatory arbitrage
Increase in cross-border banking over time

Source: Claessens and van Horen (2013)
Percentage of foreign banks among all banks in 2009

Source: Claessens and Van Horen (2013)
Biased supervisory incentives to intervene in cross-border banks

CDS spreads of large (mostly cross-border) banks three days before intervention during 2008/9 crisis; Source: Beck, Todorov and Wagner (2013)
Pre-2007 arrangements turned out to be good for sunny days only

- Colleges of supervisors
  - At the end, everyone for him/herself
- Memorandum of Understanding
  - Not legally binding
  - Value falls with equity in bank
- Missing player at table
  - Minister of Finance as representative of taxpayer

Need for stronger arrangement that work during crisis times!
...but one size does not fit all

- Differences in legal systems
- Differences in preferences
  - On government intervention
  - On fiscal independence
  - On return-risk trade-off
- Informational and interest asymmetries
  - Small host country with market-dominating foreign subsidiary (e.g., Uganda) vs. large home country for whom foreign subsidiary does not matter (e.g., UK)
Heterogeneity

Supervisory colleges, MoUs

Asymmetric home-host country interests: stand-alone subsidiaries

Strong ex-ante agreements on resolution and burden-sharing

Broader cooperation among stakeholders; regulatory convergence

Closer cooperation, especially on G-SIFIs, regulatory convergence

Joint regulatory and supervisory authority
Need for cross-border bank regulation varies across regions/country pairs

- Low externalities, high heterogeneity: Memorandum of Understanding, Colleges of Supervisors
  - India,…. Low share of cross-border banking, “closed” financial systems

- Low externalities, low heterogeneity: move towards extended versions of MoUs and colleges
  - East Africa: joint historic background

- High externalities, high heterogeneity
  - US/Europe/Japan – Europe/UK
  - Focus on G-SIFIs, coordination on market support

- High externalities, asymmetric interests
  - Stand-alone subsidiaries
  - Latin America, Sub-Saharan Africa vis-a-vis European/US banks

- High externalities, low heterogeneity
  - move towards closer cooperation: extended versions of MoUs and colleges; ex-ante burden-sharing agreements
    - Nordic-Baltic

- Banking union
Externalities

- Heterogeneity
  - Supervisory colleges, MoUs
    - Closer cooperation, especially on G-SIFIs, regulatory convergence
    - Asymmetric home-host country interests: stand-alone subsidiaries
    - Strong ex-ante agreements on resolution and burden-sharing
  - Closer cooperation, especially on G-SIFIs, regulatory convergence
  - Broader cooperation among stakeholders; regulatory convergence

- Joint regulatory and supervisory authority

Externalities
The Eurozone crisis

- Many special cases!
- But one common thread: close ties between government and banks
The Eurozone crisis – a tragedy of commons

- Compare Nevada with Ireland
- Interest to share the burden, through ECB’s liquidity support or Target 2
- Eurozone decisions are sum (or smallest common denominator?) of national interests
- Nobody internalizes externalities
- No Eurozone authority
How can a banking union help?

- Address macro-economic imbalances, exacerbated by national regulation and supervision of Europe-wide banking groups
- Risk diversification
- Tackle bank fragility in several periphery countries
  - Overcome regulatory and political capture
  - Will ECB be really a more stringent supervisor?
- Help address Eurozone’s Tragedy of Commons problem
  - Interest of every member government with fragile banks to “share the burden” with the other members, be it through the ECB’s liquidity support or the TARGET2 system
  - the ECB and the Eurosystem are being used to apply short-term palliatives that deepen distributional problems and make the crisis resolution ultimately more difficult
- Restoring bank soundness and thus bank lending is a critical part of the “growth compact”
Banking union for whom?

- Degree of regulatory integration is a function of externalities
- Cross-border flows – coordination
- Cross-border SIFIs – joint framework, CoS, MoUs…
- Currency union – specific externalities
  - Link of financial and monetary stability
  - Lender of last resort
  - Burden-sharing – tragedy of commons
- What does mean for Europe:
  - Full-fledged banking union for Eurozone, for all institutions
  - More institution-focused coordination and cooperation for non-Euro countries
    - Example: Nordic-Baltic MOU
  - Alternative options: associate members of Single Supervisory Mechanism
Banking union with just supervision does not work

- Centralizing supervision alone, while leaving bank resolution and recapitalization at the national level, is not only unhelpful but might make things worse
  - Supervision without consequences
  - Walking zombies that cannot be resolved
  - Cannot solve vicious cycle between bank and sovereign fragility
- Banking union for all financial institutions, not just large institutions
  - Monetary and financial stability linked through systemic channels, not just large institutions
Part of larger reform effort

- Need to address sovereign fragility as well
  - European Redemption Pact
  - Need to cut link between bank and sovereign fragility that has caused downward economic spiral in several periphery countries
- Adjustments in regulatory framework for sovereign debt holdings
  - Adjust capital charges and liquidity requirements
  - Concentration limits
  - Sovereign insolvency regime
A banking union is needed for the Eurozone, but won’t help for the current crisis!

- Status quo: short-term fixes with enormous pressure and burden on ECB and piece-meal approach to long-term reform
- BUT: Urgent need to address banking and sovereign fragility – transitional solutions
  - Suggestion: **European Recapitalization Agency**
  - Banking union takes longer time to build necessary institutional framework
- Don’t mix crisis resolution with long-term reforms
  - Introducing insurance after the accident
  - Distributional fights
  - Political sensitivity
European recapitalization agency

- Temporary asset management company to restructure and resolve weak banks across the Eurozone
- Could be housed at ESM
- Where possible, banks should be recapitalized through the market
- If not feasible, recapitalize by taking an equity stake
  - Receive upside as well!
  - Bail-in of junior and possibly some senior debt holders
- Need for fiscal backstop from ESM
Conclusions

● Lots of progress on resolution on national levels
  ● From a very low level!
  ● But questions remain about implementation and preparedness
● Need for addressing cross-border regulatory cooperation
  ● Look beyond sunny-day arrangements
● Eurozone agenda still wide open
  ● Single Supervisory Mechanism by itself will NOT help, might make things worse
  ● Crisis resolution keeps getting postponed
Thank you

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