Yves Mersch: Shaping a new regulatory framework – international banking at the crossroads

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the conference "The Emerging Framework to Strengthen Banking Regulation and Financial Stability", organised by the Financial Stability Institute, BIS, and hosted by the Arab Monetary Fund, Abu Dhabi, 8 November 2010.

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Let me start by thanking the Arab Monetary Fund and the FSI of the BIS for providing the opportunity to present my views on financial sector reform in the post crisis era from the perspective of international banking. The topic is vast, and I shall not attempt to deal exhaustively with its numerous dimensions, but rather concentrate myself on one key component, namely cross-border banking flows. I will describe their main drivers, explore their impact on financial stability, and review major reforms currently discussed and aimed at maximizing the benefits of international banking.

International banking: drivers, effects and impact on financial stability

Cross-border flows have expanded enormously in the last three decades. Since the second half of the 19th century, the internationalization of banking has proceeded in several waves. The most recent waves followed the liberalization of the early 1980s and the expansion of subsidiaries and branches in emerging and developing economies since the second half of the 1990s. Measured by the expansion of cross-border lending and the local claims of foreign banks, the scale of international banking increased dramatically since the beginning of 1980s, also in the Gulf States (Figure 1).

While international claims vis-à-vis developing countries are less than 20 percent of claims to developed countries, there has been a recent acceleration of the former. In the last half of this decade, the increase in the share of loans to non-banks in the Gulf States is noticeable, and it reflects the internationalization strategy of banks which have favored extending credit by local affiliates to cross-border lending. Until the beginning of this decade, international banking growth tracked well the increasing world integration as measured by international trade growth. More recently, however, cross-border flows have grown faster than international trade reflecting the emergence of risk transfer and securitization thus making international banking an important component of a broader process of globalization and integration. Capital flows have not been uniformly distributed across countries, and a cross-country analysis of net international positions show large imbalances and persistent net creditor and debtor positions (Figure 2).

The most important* ultimate *macroeconomic drivers of international banking are the regulatory environment and technological developments. While maximizing shareholders' value is banks' objective, the ultimate drivers of international banking are macro drivers in home and host countries, and micro drivers related to bank-level efficiency. A 2008 survey of internationally active banks in Europe conducted by the ECB indicates that the international expansion of banks is driven primarily by the pursuit of new business opportunities and by incentives to follow their non-financial customers abroad. Consistent with the results of the empirical literature, economies of scale and scope play a relatively minor role. The liberalization of international trade and capital markets has increased economic integration and interdependence. Restrictions to foreign bank entry have been gradually eased by bilateral and regional trade and investment agreements as well as by multilateral liberalization efforts under the umbrella of the World Trade Organization. During the last quarter of a century, deregulation and a trend toward the international harmonization of banking supervision and market infrastructure have enhanced economic integration and international banking activities.

By reducing the costs of foreign operations, deregulation has fostered M&A, greenfield investment and the provision of cross-border financial services and new products. This was clear in the EU with the “single banking license” of 1989 and the 27 directives implemented by member states under the Financial Services Plan. This has also been the case with innovation through Islamic banking financial products (e.g., sukuk) which have increased integration and interconnectedness of monetary and capital markets and is further pursued by recent initiatives like International Islamic Liquidity Management Corporation (IILM). Traditional banks have opened affiliates in Islamic countries and banks from these countries have entered traditional markets. These developments have led several EU countries, including Luxembourg, to modify their legal frameworks to facilitate these transactions by reducing instances of double taxation. In addition, wholesale activities were boosted in the Euro area by the creation of TARGET, a platform for an efficient cross-border payment system, TARGET 2, a completely integrated IT platform for cross-border payments, and starting in 2013, T2S, a single IT platform for cross-border security settlement. Finally, technological advances have boosted the effects of economic integration on international banking by improving access to information on borrowers and on collateral, and by facilitating the development of models to value credit risk, price new securities, and manage risks more efficiently.

The macroeconomic conditions in home and host countries also drive international financial flows. First, regulatory and economic developments *in home* countries affect the international activities of banks. For instance, the development of the Eurodollar market resulted from U.S restrictions on interest paid on deposits within the U.S., and the U.K. government restrictions on sterling lending by U.K. banks. Similarly, prior to 1999, U.S. banks established subsidiaries abroad to undertake investment activities that restrictions on universal banking made impossible at home. Second, there exists ample evidence of a positive correlation between economic development and financial sophistication. Third, increases in domestic market competition are behind the international expansion of banks faced with the decline in their margins. All that said, in deciding on their internationalization strategy, banks also take into account the growth prospects and the state of economic, political, and legal development of the potential *host country*. First, macroeconomic and financial stability in host countries are important drivers of foreign bank lending. It is estimated that the elimination of currency risk increased banking activity in the Euro area 25 percent. Second, banks prefer countries that have a low cost of information gathering; the existence of credit bureaus has been found significant in making a country more attractive to international banks. Third, international banks tend to prefer countries with attractive deposit insurance regimes otherwise they operate through non bank vehicles for market sensitive funding sources. Finally, banks that are successful in incorporating host country’s characteristics can boost their comparative advantage vis-à-vis other banks. These factors may be cultural or geographical proximity, for example. As an illustration of some of these factors as well as of the interconnectedness of world capital markets, Figure 3 displays nodes to describe countries/regions of banks’ location with the size of the nodes proportional to the size of the share of banks’ cross-border assets and liabilities, and the thickness of the lines as a measure of the amount of finance across nodes, both in U.S. dollars and in Euros. In the lower panel, cumulative net capital flows are depicted by the thickness and direction of the arrows. Up to mid-2007, capital flew out of Japan, the Euro area, Asian financial centers and oil-exporting countries (via offices in the U.K. and the Caribbean) toward the U.S. and emerging markets. After the crisis, the direction of most capital flows was reversed. In particular, funds flew out of the U.S. and back toward the U.K.

Luxembourg is not on the picture, not because of non availability of data as a recent IMF paper wrongly states, but because the IMF has neither consulted the ECB, or the BCL, its website, or its publications.

International banking has enhanced economic growth and efficiency, but has affected the distribution of risks as well. Cross-border flows have facilitated the transfer of financial innovations and increased income in recipient countries; have improved allocative efficiency by making it possible for host borrowers to tap international funding sources and by reducing their costs of funding owing to increased competition. Finally, international banking has been a catalyst of financial sector reforms in host countries, which have in turn increased potential growth. On the other hand, reliance in foreign lending, as exemplified in recent times of stress, can be riskier than reliance on purely domestic lending sources. During times of turmoil, overseas funding may dry up for financial and non-financial firms, while banks supplying funding overseas may experience credit losses and liquidity hardships. During the last quarter of 2008, for instance, cross-border lending fell by nearly two trillion U.S. dollars (at constant exchange rates) against a drop of 0.5 trillion U.S. dollars of foreign banks' local claims in local currencies. From the banks' viewpoint, the risk profile and resilience of banks is also affected. Diversification of a bank's counterparties does reduce its risk profile; it has been observed that during the crisis more diversified banks suffered lower losses (this despite that research has found that more diversified banks tend to hold riskier portfolios). Similarly, although cross-border banking induces banks to exploit the riskreturn frontier along its international dimension, the ensuing efficiency increase has not always been associated with better risk measurement and management practices.

The profile of systemic risk has been also affected by the increase in the financial system interconnectivity inherent in international banking. The international activities of banks allow risk sharing, reducing thereby the probability of financial crises, and according to the literature, also the procyclicality of lending. Parent-subsidiary relations make it possible, as exemplified during the last crisis, that whether due to reputation or other considerations, parent companies support their affiliates in times of duress. However, as experienced in my own country, it would not be wise to expect that behavior consistently at all times. The health of the parent company may not allow it to support its affiliates, and even force it to rely on its affiliates for funding. In Luxembourg, a traditional net provider of liquidity to banks' parent companies, this risk is less serious, but cases of sudden stoppages of cross-border funding are too numerous to be ignored. They offer clear lessons as to the potentially very damaging impact of sudden halts in cross-border capital flows on countries' credit supply and growth. By its own nature, international banking increases the degree of interconnectivity of the financial system and may exacerbate contagion risk, and increase the speed with which shocks are transmitted. In addition, a current concern is the fluidity and comprehensiveness of information flows among national supervisors, between supervisors and financial institutions, and among financial institutions. This aspect of cross-border banking increases systemic risk. As documented by a recent CGFS study on funding patterns and liquidity management of internationally active banks, information frictions were at the origin of large currency mismatches of international banks which complicated the crisis management. Information issues also plague crises resolution and, especially, burden-sharing arrangements. So, I turn now to what is being done to design a new, more robust, regulatory framework for international banking.

International banking and the emerging regulatory framework

The crisis highlighted deficiencies in the way certain international banks conducted their business and managed financial risks, but also disclosed regulatory failures. The interconnectedness of the global financial system became evident during the crisis as the geographically diversified portfolios of certain internationally active banks became channels of transmission of distress across borders; cross-currency mismatches put severe pressure on some banks' capital and transmitted liquidity shocks across markets; underpricing of risk led to unsustainable leverage levels; opaque and complex asset positions plagued certain large international banks' balance sheets; reliance on international capital markets for funding grew enormously in the run up to the crisis so that capital markets and banks became inextricably linked well beyond their usual complementarities; international trade flows suffered from sudden reversals of capital flows as banks took remedial actions, including by curtailing credit. National supervisory frameworks and pre-crisis world capital and liquidity standards were insufficient for preventing the crisis; were revealed to be inefficient and costly for managing it and; offer no clear way out of the current situation due to the lack of a harmonized set of rules for crisis resolution and burden sharing.

Despite the fact that the new Basel proposals aim to improve the regulatory framework on for instance capital, liquidity and leverage requirements and are expected to increase the resilience of banking systems in the near future, this new regulatory regime contains some questionable elements. In this regard, it is worth recalling that the leverage ratio does not account for the real risk of assets in addition to ignoring bank-specific business models – even if universal banks have been proven to be more resilient than investment banks (see figure 4)

Indeed, diversified banks were not the main channel underlying the spread of the subprime crisis that originated in the United States. Rather it was the investment financial institutions, including the shadow banking system, that seemed to be the main vehicle of contagion. Recent IMF figures displayed at the last IMFC meeting, usefully underpinned by 2 documents "Understanding Financial Interconnectedness", (see figure 5) provide evidence that the level of financial interconnectedness of the shadow banking system, in contrast with banking system linkages, might explain the rapid process of crisis transmission.

The crisis occurred against a background of EU financial stability frameworks built on a national basis. In the EU, each country's supervisory authorities derive their legitimacy from national parliaments, are subject to national accountability mechanisms, and are financed nationally. A set of MOUs make each country's authority responsible for the consolidated supervision of financial institutions domiciled in that country, the home supervisor, while host supervisors are responsible for subsidiaries of institutions from other countries operating in their territories. Each national central bank is responsible for providing ELA to financial institutions domiciled in its territory with the obligation of informing the ECB. The EU had concluded two MOUs to deal with crossborder issues in crisis management: the 2003 MOU on high-level principles of cooperation between banking supervisors and central banks, and the 2005 MOU on cooperation between banking supervisors, central banks and finance ministries. MOUs have been signed to deal with banks of regional systemic importance as well. In turn, colleges of supervisors are responsible for monitoring insurance groups and some banks. Committees in charge of developing guidelines for the functioning of supervisory colleges and the assessment of financial sector vulnerabilities report to the Financial Stability Table of ECOFIN. EU regulations are applicable to all EU countries (e.g., CRD, MiFID, and Solvency II), but countries can choose the form and methods by which to implement those regulations nationally. The EU Commission has enforcement powers in matters related to the completion of the common market, and thus on mergers and acquisitions of financial institutions and injections of state capital. Finally, international organizations and international standard setters such as the BIS, the IMF, the FSB, IAIS and IOSCO also affect EU legislation. But the crisis made it clear that in the EU as well as in an increasingly integrated world, uncoordinated national policies and highly disparate regulatory regimes are inconsistent with the objective of preserving financial stability.

The crisis exposed the costs of the national model of crisis prevention, management and resolution prevailing in the integrated EU market. When the crisis hit, crisis prevention was underdeveloped in the EU. While there had been significant progress in setting standards (e.g., via the CRD), there was no agreement on a common set of procedures for early action or for remedial action; it existed in various different degrees of discretion in the use of sanctions across member countries as well as a wide degree of central banks' involvement in national liquidity surveillance. Regarding crisis management, the CRD, the FCD, and the 2005 MOU had set the trend toward more information sharing and improved allocation of responsibilities in case of crisis. However, a harmonization of rules for remedial action based on early intervention and rapid, low cost, decision-making was missing. In the case of existing ELA arrangements, host countries, while responsible for ELA for subsidiaries and branches, did not have access to supervisory information about branches, and had some difficulty in assessing the risks involved in their ELA operations. Costs of intervention remained opaque; host country authorities did not have the incentive to provide liquidity support because of EU ring-fencing prohibitions; home-country authorities delayed provision of information or taking crisis-management actions to avoid capital losses, reputational effects or political backlashes; the home authority did not always have the incentive to keep host authorities reasonably informed. Finally, given that crisis resolution is fundamentally national, countries' approaches to financial institutions' failure vary. Most countries have only a few bank-specific regulations; instead, general commerce bankruptcy laws often apply which delays the process of dealing with insolvent banks, even prohibiting in some cases their recapitalization. In the case of a large and complex financial institution (LCFI), the focus of bankruptcy law is in some countries on the right of claimholders and in others on the right of debtors, often incompatible with a cost-efficient solution. In addition, there were differences across countries regarding deposit insurance (e.g., definition of deposits, co-insurance, risk-based premia, and funding).[1] This state of affairs increases the regulatory burden, provides incentives for regulatory arbitrage, hinders competition, exacerbates moral hazard, uses taxpayer money to save inefficient firms, endangers the EU integration process, and is inconsistent with financial stability.

World and EU financial stability frameworks are evolving with the aim to enhance crisis prevention, management and resolution for cross-border financial institutions. In 2008, given the costs of the crisis and the Nordic experience, the EU proposed an MOU on cooperation among supervisors, central banks and ministers of finance on cross-border financial stability. This was a key step in establishing a series not only of principles, but also procedures to exchange information and cooperation among countries in normal times in order to prevent, as well as to manage and resolve, cross-border crises. The 2008 MOU includes prescriptions for coordinating public information, conducting stress-testing exercises and establishing contingency plans. It remained, however, a voluntary framework which does not fully solve the tension between home country lead responsibility for integrated supervision and the host country responsibility for financial stability. In 2009, the Larosière Report and the European Council agreed on the need to build a comprehensive cross-border framework for the prevention, management and resolution of financial crises in the EU. The Financial Stability Board (FSB) published principles for cross-border cooperation on crisis management stressing the role of supervisory colleges. These principles enhance incentives for financial institutions to behave prudently; promote private sector solutions and limit public intervention only when necessary to preserve financial stability and; keep a level playing field. Supervisory cooperation took a big step forward with amendments to the CRD as a 2009 EC Directive made compulsory the colleges of supervisors for banks with significant subsidiaries and branches in the EU. Chaired by the consolidating supervisor, the colleges have the objective of exchanging information; determining risk assessment programs of the banking groups; leveling the playing field in terms of application of the Directive in the concerned Member States. Finally, last May, the Council of the EU decided the establishment of Cross Border Stability Groups for all large EU cross-border groups by mid 2011 accompanied by the signature of Cross-Border Cooperation Agreements.

Recognizing the insufficiency of the microprudential approach to deal with systemic risks, the European Parliament approved a new crisis prevention framework which also considers the systemic risks posed by international banks. It is now generally accepted that microprudential regulation and supervision of individual institutions and

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1 A 2009 EC Directive increased the coverage of deposit protection to 100.000 Euros starting end-2010. A July 2010 EC proposal of Directive seeks a further harmonization of EU deposit insurance schemes and a reduction of the reimbursement period, as well as mechanisms to guarantee the financing of the schemes.

markets, while necessary, is not sufficient because it does not take into account the interactions among financial institutions and between financial institutions and the real sector. The European Systemic Risk Board (ESRB), a key component of an integrated micro-macro European System of Financial Supervisors (ESFS), will be operational at the beginning of 2011. It will be responsible for macro-prudential oversight to prevent or mitigate systemic risks, enhance early warning mechanisms and facilitate the translation of risk assessments into action so as to avoid episodes of widespread financial distress, to enhance the smooth functioning of the internal market, and ensure a sustainable contribution of the financial sector to economic growth. The ESRB can issue warnings and recommendations for action, which while not binding for the addressee, inaction by the addressee will have to be explained. The three microprudential components of the ESFS will start their supervisory activities at the beginning of next year. These new authorities will be born from the transformation of the existing 3L3 committees into a European Banking Authority (EBA), a European Securities and Markets Authority (ESMA), and a European Insurance and Occupational Pensions Authority (EIOPA). The network of national financial supervisors will work together with the new European Supervisory Authorities (ESAs). The new bodies will be built on shared and mutually-reinforcing responsibilities, combining nationally-based supervision of financial institutions with specific tasks at the European level; will foster harmonized rules and coherent supervisory practice and their enforcement.

Other initiatives at the world level are intended to promote sound practices for colleges of supervision. The EU supervisory framework addresses cooperation in supervision in general and also by colleges. The Committee on European Banking Supervisors (CEBS) is currently developing guidelines for their operational functioning. The CEBS has also developed an MOU template to be signed at the end of 2010 not only by EU supervisors, but also by EEA relevant authorities. However, many EU financial institutions are truly global, and thus it is important to mention that also the Basel Committee on Banking Supervision (BCBS) has put out a set of eight good practice principles on supervisory colleges. The objective of supervisory colleges is to enhance information exchange and cooperation among supervisors in order to support the effective supervision of international banks.

In the EU, a framework for cross-border crisis management in the banking sector is just in its gestation period. Research unequivocally shows that coordination failure is a distinct possibility in a cross-border setting. Therefore, ex-post negotiations on burden sharing lead to under-provision of recapitalization; in contrast, an ex-ante burden-sharing mechanism might encourage moral hazard. In this vein, measures have been taken to upgrade deposit insurance, as I said earlier, to strengthen capital requirements and to reform the EU infrastructure to prevent crises. Yet, a framework to enable authorities to control the impact of a failing cross-border financial institution is still missing. Therefore, mindful that the costs of uncoordinated national resolution increases with the degree of interconnectedness and integration of financial institutions, last month, the EC issued a communication proposing the building blocks of an EU framework for cross-border crisis management in the banking sector. According to this communication, the objectives of the framework are twofold: first, to ensure that national supervisors have tools to identify problems in banks at an early stage so as to be able to intervene to restore the institution's health or to prevent its deterioration; second, to make crossborder banks' failure possible without contagion and without disruption of banking activities. The framework is very ambitious as it covers early preparedness, preventive as well as intervention measures, resolution and insolvency principles. The full implementation of the framework would pose significant challenges under the present state of European integration, in particular with regard to issues related to burden sharing, intra-group asset transfers during periods of crisis and heterogeneity of insolvency laws within the EU. In this context, it may be more realistic to pave the way for a second best approach i.e. a nationally based framework for cross-border crisis management associated with a binding process for cooperation and information exchange.

The establishment of ex-ante bank resolution funds may also contribute to the reduction of moral hazard and increase financial stability. The EC communication to the EU bodies proposes the establishment of national bank resolution funds. These would be funded by a levy on banks so as to facilitate the resolution of failing banks avoiding thereby contagion and sales of bank assets under stress. Bank resolution funds should not be viewed, however, as insurance against failure or to bail out failing banks. Funds are part of the set of tools of a financial stability framework that includes crisis management, and are intended to palliate, at least partly, the stability implications of the failure of LCFIs. In Luxembourg, the Central Bank has suggested an innovative framework for an ex-ante bank resolution fund through the establishment of a privately pre-funded structure covering both issues of an orderly resolution, i.e Deposit guarantee scheme (DGS) and Bank resolution fund. In order to avoid any conflict of interest or misallocation of DGS reserves, this shall be an earmarked component of the fund. In addition, this framework is designed such that liquidity constraints taking effect during a transitional period would be minimized in order to safeguard the flow of capital into the bank resolution fund. This can be ensured via a dual mechanism which allows for the substitution of loans granted to the fund by the purchasing of an equivalent amount of bonds issued by contributing credit institutions.

At the global level, the Cross-border Bank Resolution Group of the BCBS issued last March ten recommendations for addressing the challenges posed by cross-border bank resolution.

Concluding remarks

I remain confident that the new macroprudential architecture will contribute to a more stable financial system that will permit maximizing the benefits of capital flows. Let me finish with a pragmatic quotation from Goethe: “Knowing is not enough; we must apply. Willing is not enough; we must do.” I believe we are applying what we learnt; I also believe we are establishing a new foundation for safeguarding financial stability. However, it should be noted though, that the views on the new micro-prudential regulation framework are still diverging.

Questions are still under discussion especially in view of global standards applied to heterogeneous financial systems. Level playing fields considerations loom not least in accounting rules. And the European authorities have made it clear that this time around geographical implementation has to be done time congruently.

Cross border financial activities have played a positive role in the process of globalization. At the same time they have enhanced the need for ever closer cooperation among competent authorities. Bodies for international standard setting therefore ought to include representatives from international financial centers. Systemically important financial centers should clearly play a distinguished role in the international post crisis architecture. In this respect, I fully concur with the suggestions for the way forward in the latest IMF paper.

Thank you for your attention.

Figure 1 - Gulf States' Banks International Claims
(share of Gulf States GDP)

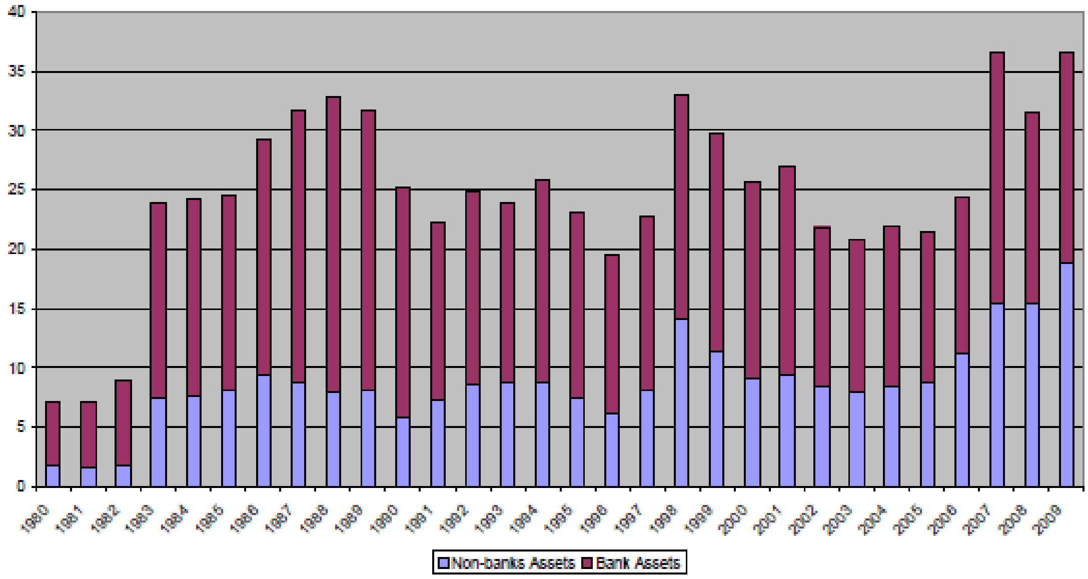
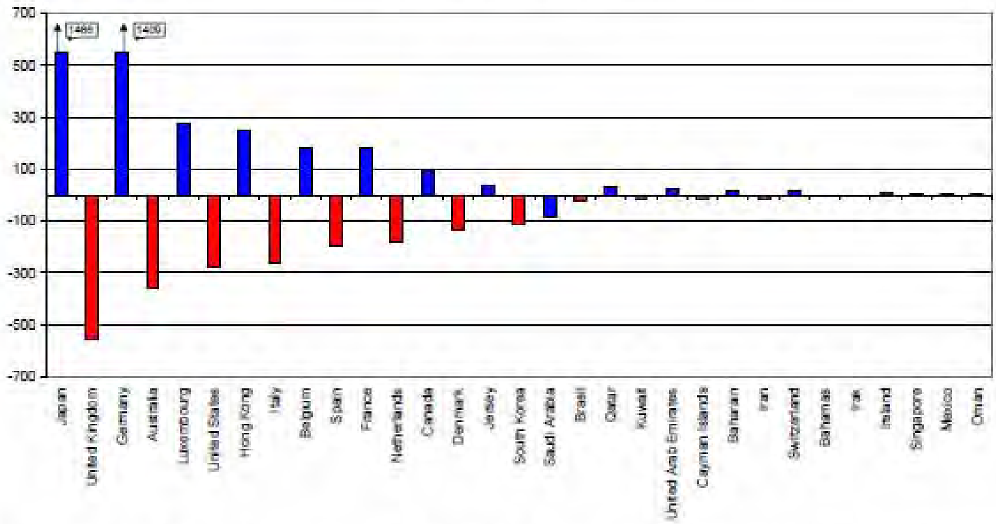
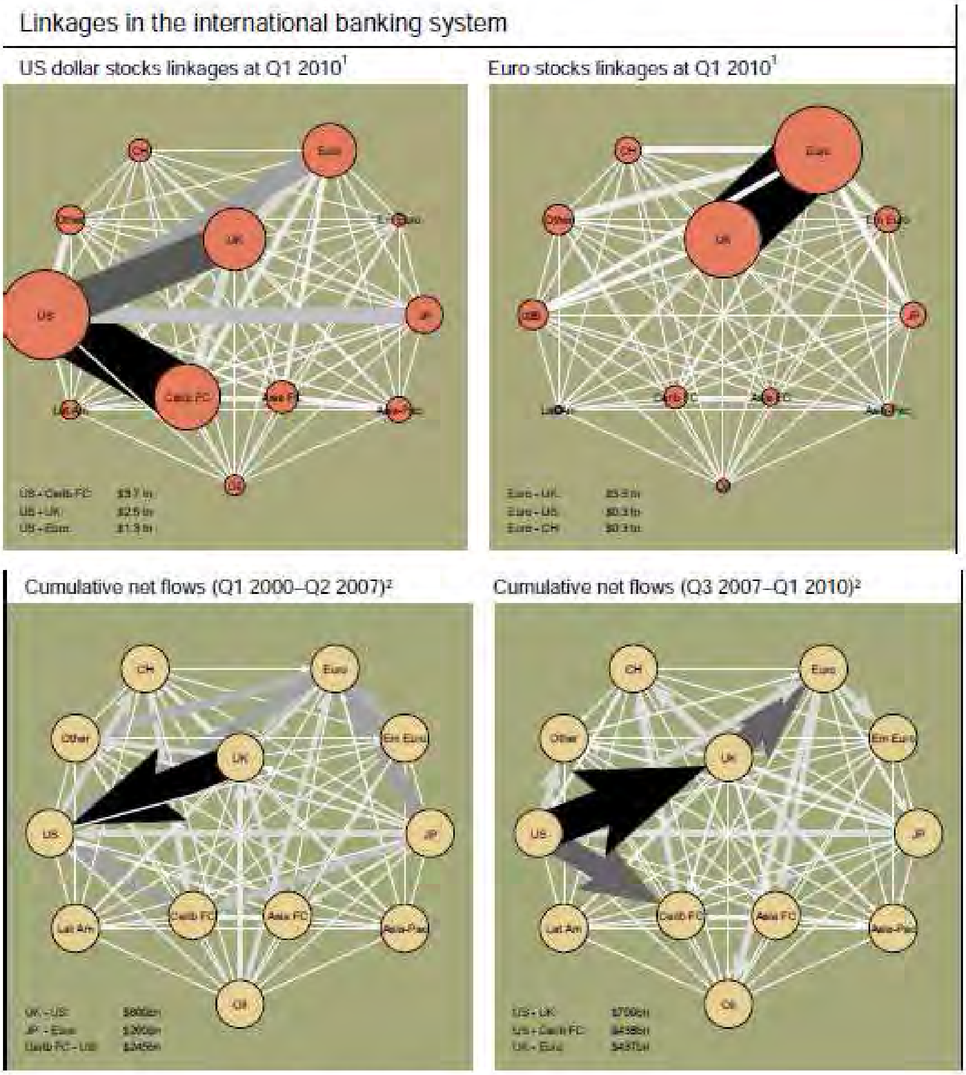


Figure 2 - Net Cross-border Banks' Assets and Liabilities
(billion US dollar; end-2009)



Source: data for Gulf Countries is from BIS, reporting countries' base; for other countries is from BIS, countries' data bases.

Figure 3



Source: BIS quarterly Review, Sept. 2010.