Már Guðmundsson: Fault lines in cross-border banking

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, delivered at Les Encontres Économiques, Aix-en-Provence, 9 July 2011.

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My comments relate to cross-border banking and are motivated and informed, on the one hand, by the rise and fall of the Icelandic banks, and on the other hand, by research and policy work that took place at the BIS, during and after my tenure there.

The financial crisis revealed major fault lines in cross-border banking. Some emerged at the global level, some at the EU/EEA level, and some at the national level. I would like to use my 10 minutes to take these in turn.

The main fault line revealed at the global level is the operation of cross-border banks with large foreign currency balance sheets featuring significant maturity mismatches, but with limited lender of last resort facilities in terms of foreign currency. The nature and magnitude of this phenomenon were not well understood before the crisis.

In this connection, let me stress that I am referring to maturity mismatches in terms of foreign currency and not currency mismatches, which was much better understood and somewhat better regulated, due to the experience gained during several past emerging market crises. Some studies still confuse these two phenomena, however, when analysing this latest international financial crisis.

Maturity mismatches are, of course, the bread and butter of modern banking, although they make banks vulnerable to refinancing risk and runs. In the case of solvent institutions, we have known theoretically since Thornton (1802), and probably over a century, as a practical policy, how to deal with that vulnerability in a domestic setting: with central bank LOLR operations, later complemented by deposit insurance.

In the current setting, it is far from guaranteed that this process can be replicated at the international level. Of course, in normal times and with developed capital markets, banks can use foreign exchange swap markets to convert domestic liquidity into foreign exchange liquidity speedily and relatively cheaply. However, this process broke down almost completely during the global run on cross-border non-US bank liabilities in the immediate aftermath of the Lehman collapse.

In a situation like this, the home central bank's ability to assist banks to acquire the foreign liquidity denied them on the market and thus avoid a failure of banks to deliver on their foreign currency payments is limited by the size of its reserves or the willingness of the central bank issuing the international currency in question to help. Although the provision of foreign currency liquidity through reserves was clearly important during the crisis, most studies seem to support the conclusion that the dollar swap lines made the crucial difference, especially when they were uncapped vis-à-vis some key central banks. To a significant degree, this was the domestic LOLR process replicated at the international level.

Does this mean that we have the solution? At the conceptual level, yes, but at the practical level, maybe not. The swap lines are not at present a permanent and a reliable feature of the international monetary system; for instance, they have been strongly challenged in political discussion in the US. Furthermore, there are important unresolved governance issues, such as who should decide which countries get a swap line and which do not. It is thus an important item on the reform agenda to clarify the extent to which standing foreign currency LOLR facilities for solvent cross-border banks can be set up. In the meantime, cross-border banking will retreat because of this risk, and smaller countries in particular will be more reluctant to provide a home base for cross-border banks.

Let me now move to the EU/EEA level. Here the main fault line is the contradiction between, on the one hand, the area-wide permission to operate based on home licensing and a common regulatory framework (the European passport) and, on the other hand, national supervision, a national safety net of deposit insurance and LOLR, and national crisis management and resolution regimes. The underlying principle is the same as in many other areas of the EU: an equal and harmonious competitive position throughout the area. In that ideal world, the location of headquarters and the size of a banking system relative to that of a country should not matter.

The crisis revealed that this framework is deeply flawed. First, it ignores the FX liquidity risk that I discussed earlier. Banks from small countries with independent currencies are more exposed to this risk than, for instance, banks within the euro are. Second, country size and bank size relative to countries matter for the viability of bailout options. To take an example, the balance sheets of Iceland's three cross-border banks were 10 times Iceland's GDP, and 2/3 denominated in foreign currencies. Nationalising them or guaranteeing their debt would have turned a failure of private banks into sovereign default and national bankruptcy. Third, the design of the deposit insurance system inside the EU violates the insurance principle of pooling, which calls for EU-wide insurance. In many applications, it also ignores the difference between insuring deposits in domestic currency and in foreign currencies. The issue here is that there is a link between the ability to stop runs through LOLR operations and the ability to insure deposits.

The bottom line is that we cannot have a level playing field in banking inside the EU/EEA, except perhaps in risk-adjusted terms, as long as the EU passport is not matched by EU supervision and an EU-wide safety net, which is the logical solution. But is it politically and practically feasible? I have my doubts. Potentially, a more practical solution would be to change the European passport system by having two types of bank licences. In that case, national authorities would licence domestic banks that would face significant restrictions on the type and magnitude of cross-border activities they would be allowed to undertake; for instance, by limiting the size of foreign currency balance sheets and maturity mismatches and not allowing collection of foreign currency deposits in foreign branches. These banks would then be supervised by the national supervisor, their deposits would be insured by the domestic deposit insurance system, and the national central bank would be their LOLR. Those banks that want a European passport would be licensed and supervised by an EU authority, however; they would be part of an EU-wide deposit insurance system, and in most cases, their LOLR would be the ECB.

Let me now say a few words about the national level. The key issue here is that, as long as global risks and EU flaws are not dealt with, individual countries are forced to take action to protect themselves: action that might contribute further to the retreat of cross-border banking. These might take the form of restricting international activities of home banks and placing much more strict prudential limits on foreign currency maturity mismatches. For example, when Iceland lifts its current capital controls on outflows, it will probably impose restrictions on both the size and composition of foreign currency balance sheets of home-headquartered banks. Some might see such restrictions as capital controls in another form, but I see them as prudential rules. In any case, both at the national and at the global level, there is a need to monitor imbalances and mismatches in banks' balance sheets much more closely than was the case before the crisis.

In the absence of global and EU reforms, the size of a national banking system relative to GDP will be a matter of concern. This will require tools within a macroprudential framework to affect the size of the banking system. Work is needed in this area.

Let me conclude by saying that, although I have focused on the fault lines and risks in cross-border banking in my remarks today, we should be aware that financial globalisation has important benefits. This gives us all the more reason to find ways to mitigate the risks.