Cross-Border Regulation and Supervision

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Duisenberg school of finance

IMF, Washington DC
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for leaders in finance

Split up or stay together?

Cross-border banking at the cross-roads, after the crisis

- Decentralised model, with national subsidiaries, or
- Integrated business model?

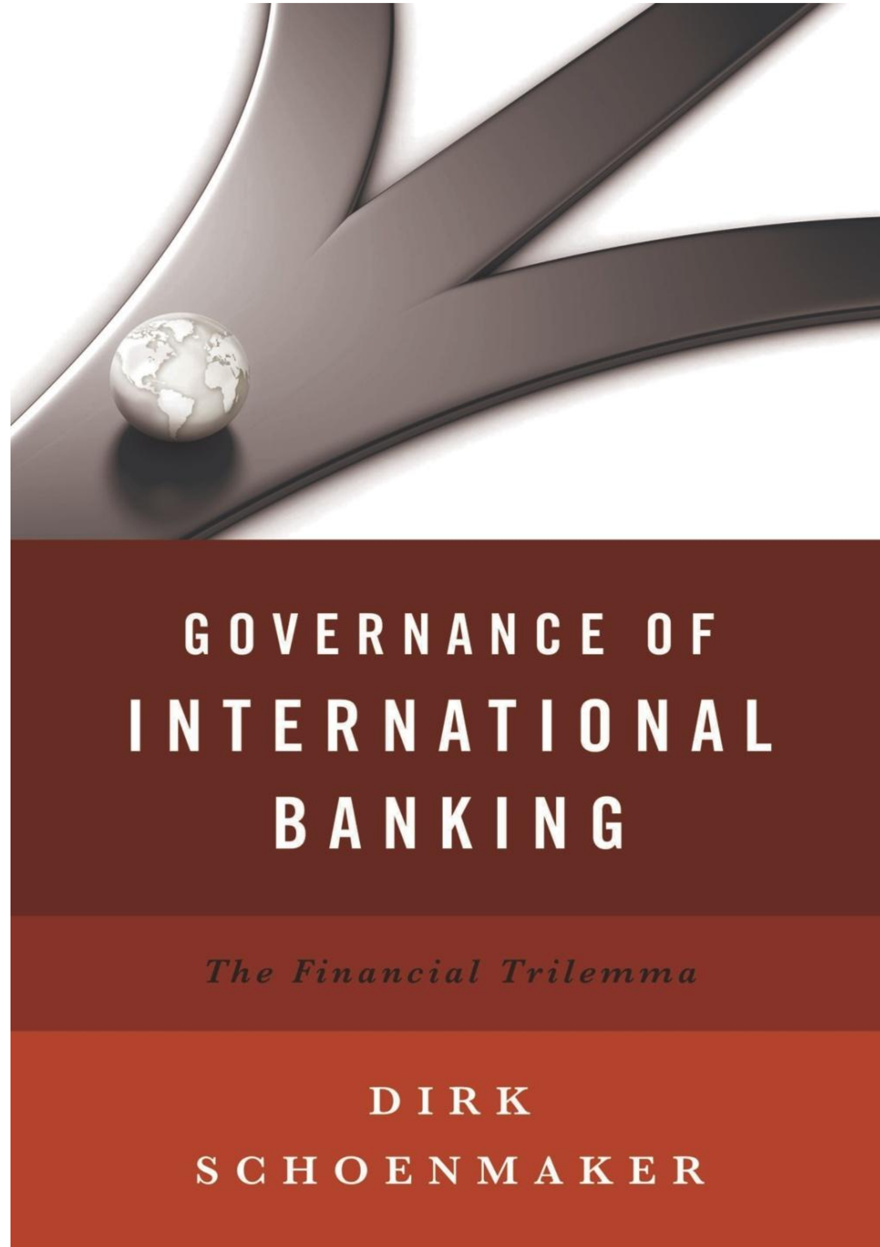
Depends on governance:

- National supervisors in charge, versus
- International institutions with a strong role

Governance of International Banking: The Financial Trilemma

Oxford University Press, New York

March 2013



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Idea behind book

1. Coordination failure between national authorities in resolving international banks
2. Develop game theoretical model to explain lack of coordination: the financial trilemma
3. Provide empirical evidence on international banking
4. Develop new governance framework
   - Political economy
   - Global and European governance solutions
5. Conclusion: policy-makers have to make a choice

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International banking

Problem:

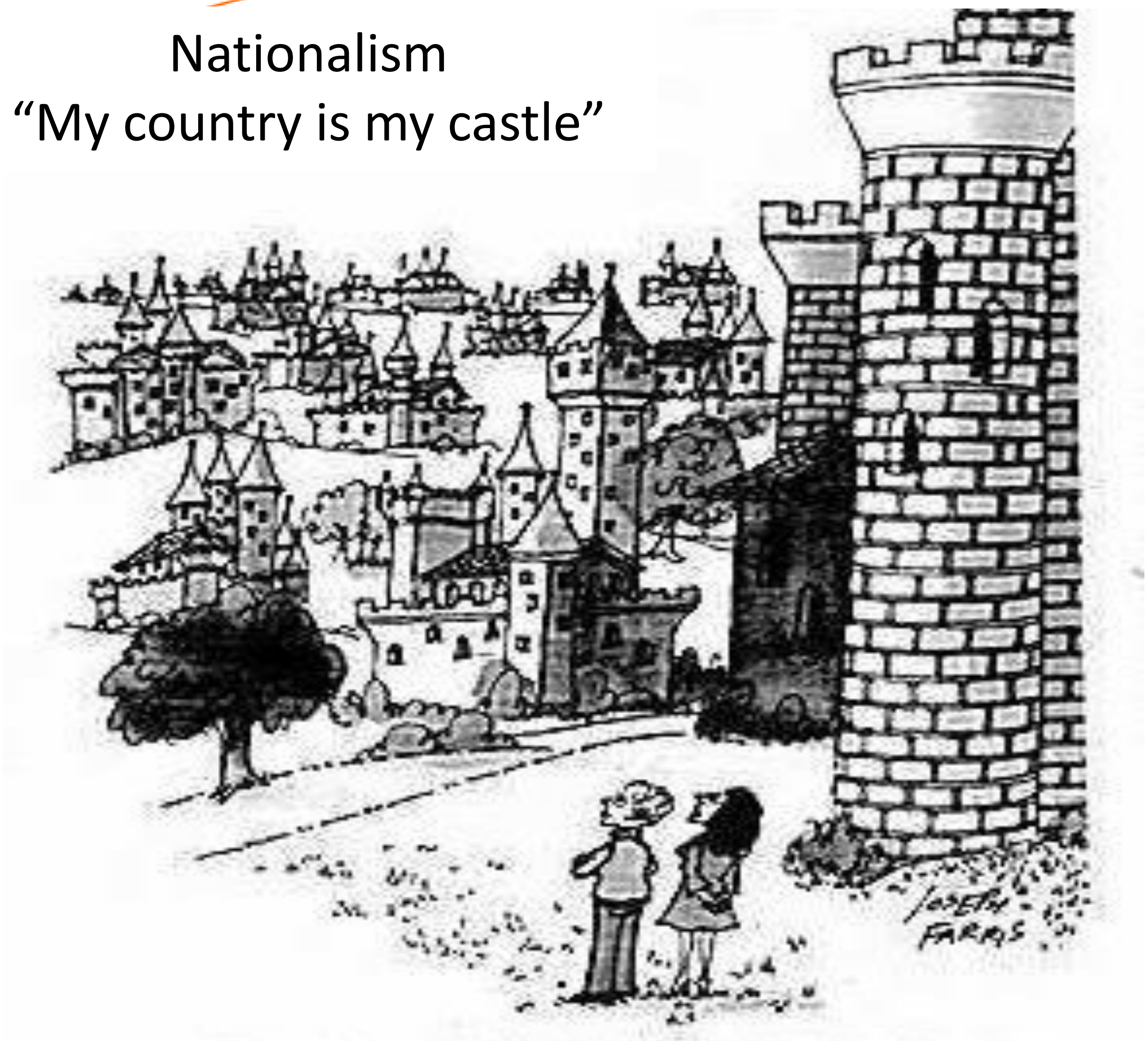
- Failure of large banks poses national and cross-border externalities
- Cross-border externalities are ignored by national authorities

Why?

- Accountability to national politics (i.e. domestic taxpayers)
- National legislation/procedures for insolvency

Nationalism

"My country is my castle"



Game theory

- Schelling (2005) and Barrett (2007) apply game theory to international cooperation
- Crisis is one shot game: no cooperation between national authorities
- Solution: ex ante binding agreement
  - hard law (treaty); soft law (MoU) does not work
  - prespecify burden sharing (no fight about key)

Financial trilemma

1. Financial stability

2. International banking **3. National financial policies**

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Two outcomes

Two stables outcomes from financial trilemma model:

1. Supra-national solutions to keep international banks
   a) Banking Union
   b) Joint supervision and resolution -> burden sharing

2. National solutions with subsidiary-based banking
   a) New Zealand (significant retail operations from Australia)
   b) US (Federal Reserve Proposed Rule) versus UK (FSA consultation)

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National approach

National approach keeps full national control, but comes at a cost

- Local liquidity pools
- Local capital buffers

Which cannot be used at the wider group in case of emergency

Liquidity pools

Example of European bank, which has to maintain local liquidity pools

- € 20 billion extra liquidity
- 1% opportunity cost for holding liquid assets

➢ annual cost of € 200 million

Local capital buffers

IMF study (Cerutti *et al*, 2010)

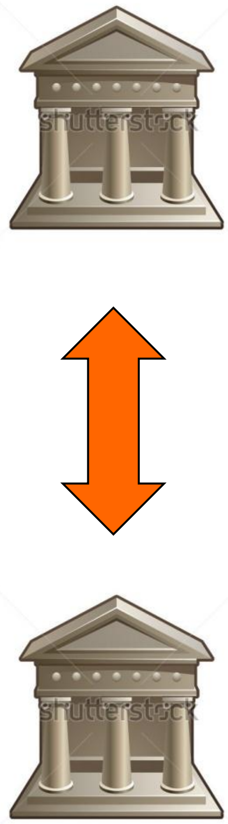
- Group of 25 European banks
- Scenario: GDP 2% ↓ and interest rates 2% ↑

Raise extra capital of

- € 45 billion in case of ring-fencing
- € 20 billion in case of no ring-fencing

UniCredit

Germany



Italy

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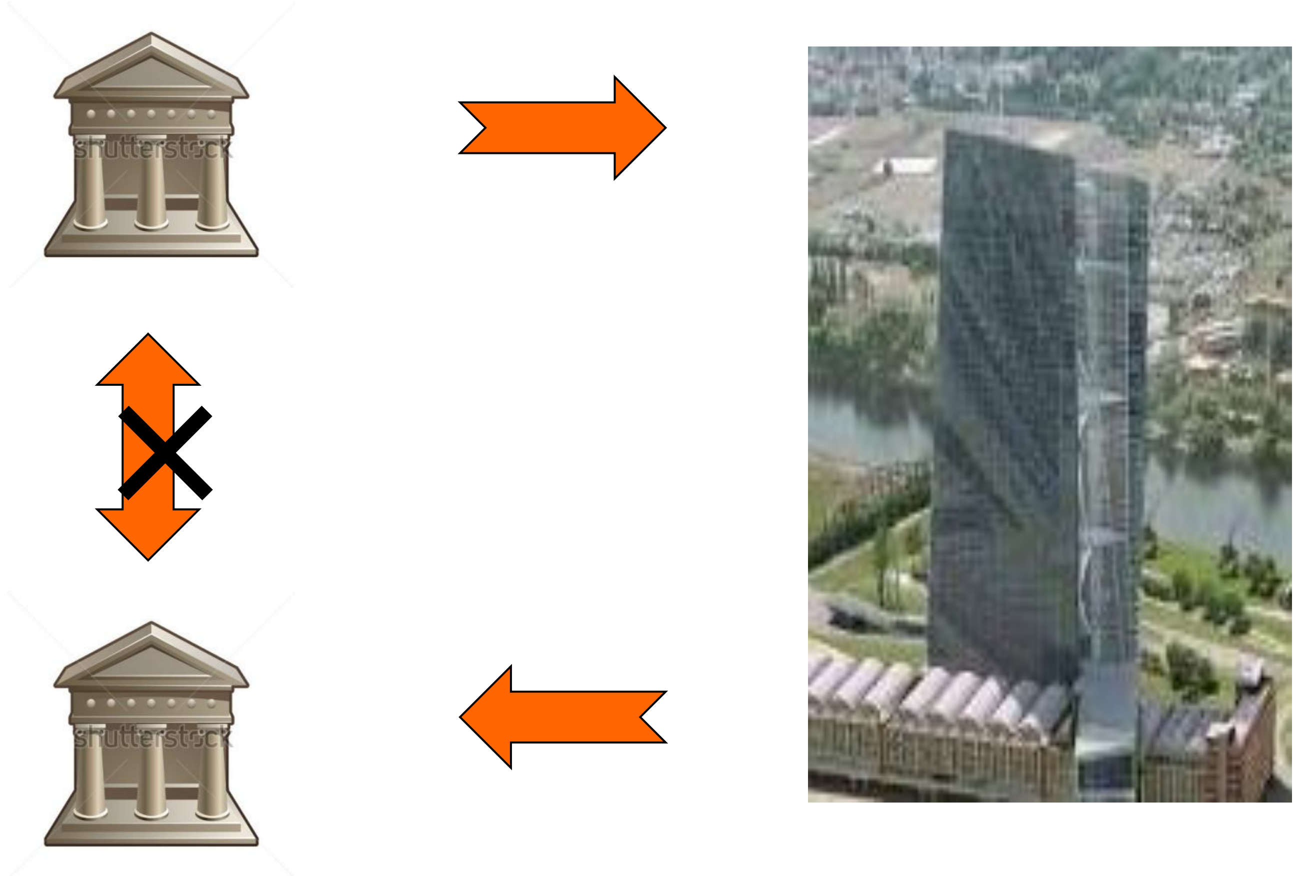
UniCredit

Germany

Italy



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Is splitting up effective?

Separate national subsidiaries, but

- Common risk management, Treasury, IT, etc
- Central management versus local independence

➢ Most importantly: reputation risk (brand name)

Extra cost will lead to higher lending costs and/or lower deposit rates without extra safety

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Stay together

- Supervisors follow political reality
- Political choice for international cooperation
- Issue of solidarity (group cohesion)
  - prepared to do burden sharing?
- But some countries fully national approach
  - US + Australia: national depositor preference

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Fiscal backstop

- Stability financial system ultimately depends on credibility fiscal backstop (Obstfeld, 2009, 2011)
  - Iceland: no credible backstop
- No world government, which can raise taxes; so burden sharing is needed
  - Europe: ESM
  - International: IMF
- But international institutions operate with one hand tied behind their back (Barrett, 2007)

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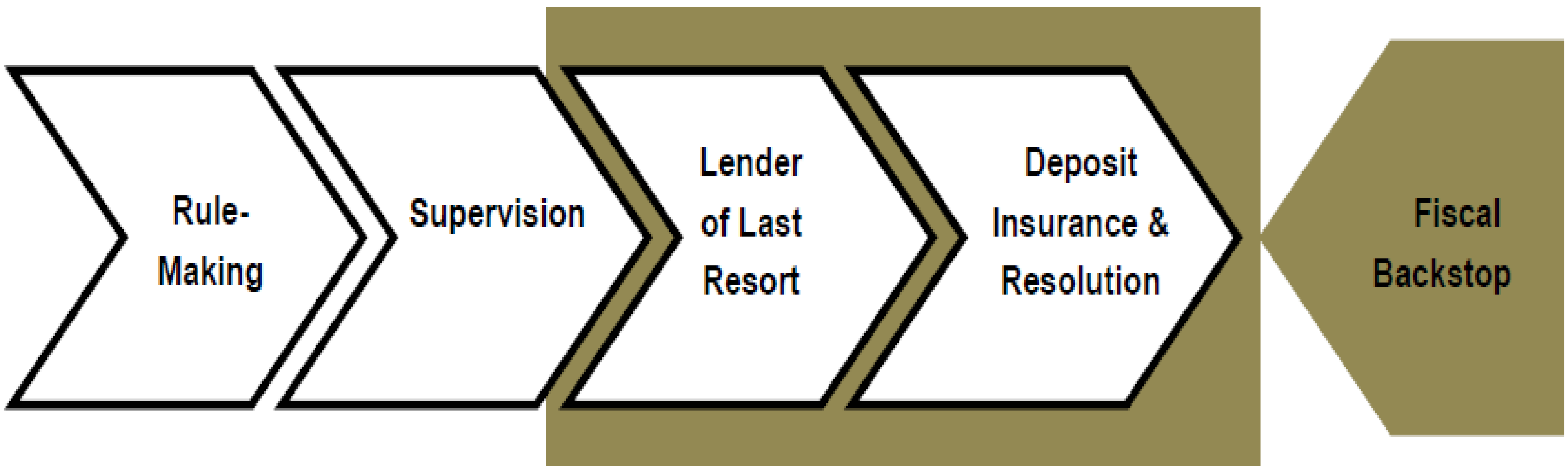
Global governance



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Conclusions

- Financial protectionism comes at a cost for banks and ultimately their clients, but will it work??

- Financial Trilemma: no way out, politicians have to choose between national and international

- For truly international banks
  - ➢ supervision and lolr by **BIS**
  - ➢ resolution + fiscal backstop by **IMF**