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**Research Report**

## Market Discipline Issues in Cross-Border Banking. A Nordic Perspective

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# Staff Memo

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Market discipline issues in cross-border banking. A Nordic perspective

by

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# MARKET DISCIPLINE ISSUES IN CROSS-BORDER BANKING<sup>1</sup>

## A NORDIC PERSPECTIVE

Thorvald Grung Moe<sup>1</sup>  
Norges Bank

### CROSS-BORDER BANKING POSES NEW CHALLENGES

Cross-border banking is on the rise. Large, cross-border banks have been established in the Nordic, Baltic and Benelux countries. Banco Santander's takeover of Abbey National made headline news last year, and this year the bid by the Dutch bank ABN Amro for the ninth largest Italian bank Antonveneta has been front-page news for months. And just lately, the Benelux group Fortis was reported to have approached the Franco-Belgian group Dexia with a merger proposal.

As cross-border banks increase in size, it is relevant to ask if stakeholders in these mega-mergers banks are exposed to the true risks involved, or if they expect the financial safety net to bail them out – should a crisis occur. National authorities could also be exposed in case of a failure in a cross-border bank, but the potential liability facing taxpayers has so far been masked by unclear home-host responsibilities for cross-border banks.

Crisis resolution in a cross-border bank is obviously the responsibility of the bank's owners and management, but previous banking crises have shown that authorities must also have contingency arrangements in place. Cross-border banks pose new challenges for policy makers. Goodhart (2005) has noted that "the interaction of an internationally inter-penetrated banking system with national regulations and burden allocation could well turn out to be a dangerously weak institutional feature."

The policy response has been to seek greater clarity in roles and responsibilities. Supervisory convergence and coordinated liquidity provision are being discussed among supervisors and central banks. Clarke (2005) even asks if an international liquidity concordat for large cross-border banks should be considered. But is this drive for convergence and agreement on intervention principles realistic? And is it desirable? What if greater clarity about roles and responsibilities were to weaken market discipline?

In the following we review some of the issues involved and discuss their possible impact on market discipline. Most of the home-host discussion has so far been centered on supervisory issues. There has been less attention to the role of central banks, especially in cross-border crisis resolution. We refer to some of the issues that have been discussed among the Nordic central banks. We conclude that international agreements on crisis resolution and burden sharing will be hard to achieve. Private sector solutions should therefore be promoted, while public authorities should take measures that will make their non-intervention policy credible.

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## MARKET DISCIPLINE REQUIRES A CREDIBLE NO-BAILOUT POLICY

There is broad agreement that market discipline should be enhanced. Market discipline has the potential to reinforce capital regulation and other supervisory efforts to promote safety and soundness in cross-border banks. This has been recognized in the new capital accord, Pillar 3. The Basel Committee “believes that market discipline, supported by an appropriate public disclosure regime, can be an effective complement to supervisory efforts to encourage banks to assess risk, maintain capital and develop and maintain sound risk management systems and practices”.<sup>2</sup>

Mayes and Llewellyn (2003) argue that market discipline can be a useful complement to prompt corrective action (PCA) by the authorities in handling problem banks. If the conditions are right, market discipline can reinforce the PCA rule, and limit the scope for discretionary intervention. However, as Llewellyn (2005) notes “market discipline is still somewhat of a “black box” and its precise mechanisms are not always clear.” Several conditions have to be met for market discipline to work and “central to the effectiveness of market discipline is the requirement that stakeholders should be exposed to losses if a bank fails,” i.e. there has to be a credible no-bailout policy.

The idea behind market discipline is actually quite simple. By trying to avoid big losses, stakeholders will put pressure on the management of the financial institutions to avoid excessive risk taking. The size of the losses will, however, depend on the authorities’ actions in troubled times. The two polar cases are (i) that the authorities will not allow the stakeholders to lose money at all or (ii) that the authorities will allow the bank to fail, leaving the stakeholders to pick up the entire bill. The effect of market discipline will therefore depend on the authorities’ resolution strategies, as perceived by the stakeholders.

During the Norwegian banking crisis the equity capital of the affected banks was written down to zero, but non-insured creditors were on the whole not affected, see Moe, Solheim and Vale (2004). Non-insured creditors were not affected in the banking crises in Finland or Sweden either, since blanket guarantees were issued. Similar experiences in other countries have led investors to expect public bailouts or excessive forbearance.<sup>3</sup> If bank creditors expect to be bailed out, then the pricing of the securities they hold in banks will not reflect the true risk of default. If these banks expand overseas, investors may continue to expect to be bailed out, even though their risk exposure has increased.

<b>Fitch long term ratings</b>		
	<b>Home</b>	<b>Host</b>
<b>Nordea (SE)</b>	AA-	
Nordea Norway		AA-
<b>Fortis (BE)</b>	AA-	
Fortis Netherland		AA-
<b>Dexia (BE)</b>	AA+	
Dexia Slovenia		A+
<b>ING (NL)</b>	AAA	
ING Belgium		AA-
ING Polen		A

Amihud, de Long and Saunders (2001) show that this is not necessarily the case. They find that investors expect domestic regulators to assist domestic banks, but not the foreign operations of their own domestic banks or the domestic operations of foreign banks. This is consistent with U.S. regulatory practice. The situation in Europe is slightly different. Table 1 show that some large cross-border banking groups have the same (long term) rating for home and host banks, while some host banks have lower ratings. Many investors thus expect the parent bank or the authorities to assist the host bank should it

get into difficulties. But are these realistic expectations? Could it be that investors are counting on assistance that will not be forthcoming? To answer these questions, it is instructive to review the current status of the home-host discussion.

## WHO IS “RESPONSIBLE” FOR RESOLVING A FINANCIAL CRISIS IN A CROSS-BORDER BANK? <sup>4</sup>

The responsibility for resolving a financial crisis in a cross-border bank clearly lies with the affected bank. Owners and managers should ensure that the bank does not end up in a critical financial situation and they also have the main responsibility for managing any crises that might arise.<sup>5</sup> However, previous banking crises have shown that authorities must also have contingency arrangements in place.

The division of responsibilities between authorities in different countries for subsidiary banks and branches of foreign banks has not really been adjusted to accommodate large cross-border banks.<sup>6</sup> Basel 2 has brought more attention to the home-host issue, e.g. in the context of validation of internal rating models and operational risk capital. European banking supervisors have also made progress in developing guidelines for home-host cooperation, see CEBS (2005). However, despite the increased attention, there remain at least three contentious issues:

- Who is responsible for handling a crisis in a subsidiary bank?
- What is the role for the host state authorities if a systemic branch gets into difficulties?<sup>7</sup>
- Will small states be able to shoulder the resolution burden of a large cross-border bank?

### Crisis resolution in a subsidiary

The Basel Committee has addressed the issue of home-host responsibility for subsidiaries in a cross-border banking structure in several reports (1996, 1999 and 2001). The potential tension between home and host regulators arises when cross-border banks transcend national boundaries and operate with global control along global business lines. If the group is allowed to “hollow out” the subsidiary, the host regulator may eventually end up being responsible for only a *de facto* branch.<sup>8</sup> There have been two recent responses to this process. In New Zealand, the central bank has tried to restrict the hollowing out process by requiring foreign banks to appoint local boards and retain core competencies.<sup>9</sup> In Europe, on the other hand, the home (“consolidated”) supervisor is supposed to coordinate and sort out any differences with the various host supervisors. The banking industry has advocated a more centralized approach (“lead supervisor”), but the resistance from host supervisors has so far prevailed; see European Financial Services Roundtable (2004). The UK Treasury (2005) noted recently that ... “any proposals for significant radical changes to the division of legal responsibilities between home and host supervisory authorities should be approached with great care and are unlikely to be feasible.”

In the Nordic countries, the development of the Nordea group has led to similar discussions among the authorities. A central bank working group was established in 2000 to review policies for a liquidity crisis in a large cross-border bank. In 2002, a joint crisis simulation exercise was undertaken together with the Nordic supervisory agencies. The exercise illustrated that “ring fencing” could easily block a joint crisis solution. A regional MoU was later signed among the central bank governors. Similar agreements have been signed among the Nordic supervisors. The MoU deals primarily with procedures for information exchange, and clarifies who should take the lead if a large cross-border bank should get into trouble. The MoU does not spell out who would be directly responsible for solving a crisis. The home country central bank, Riksbanken, has so far been reluctant to acknowledge any formal responsibility for liquidity provision in a crisis, as such a

statement could create moral hazard problems. In fact, it (Riksbanken (2003b)) even notes that "...it is unlikely that the home country would be willing to bear any costs associated with a rescue. Instead, the host country may be forced to ensure in some way that the foreign group's operations will continue."

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## The Nordea group

Nordea is a Nordic bank with a subsidiary structure founded on the four previously independent Nordic banks Merita Bank, Nordbanken, Unibank and Christiania Bank og Kreditkasse, from Finland, Sweden, Denmark and Norway, respectively. The banking group has market shares of between 15 and 40 per cent in the four countries. The bank currently operates as a group of legally independent subsidiaries, but with business segments and risk control managed across the legal structure and across country borders. The HQ of Nordea bank was moved from Finland to Sweden in 2003. Nordea has announced plans to convert the current subsidiary banks into branches and to establish itself as a European company.

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Serious liquidity problems in a large cross border bank – like Nordea Norway - should primarily be solved by the parent bank and if required be supported by the home country authorities. The fact that the subsidiary is a fully owned entity should facilitate an efficient crisis resolution. Liquidity support from Norges Bank is unlikely, since the parent bank has equity, funding and reputation at stake. If the parent bank should fail to support its subsidiary, one would expect the bank to be insolvent and LLR support will not be an appropriate instrument. I consider this position to be in line with the recent drift towards a more leading role for the home supervisor, but recognize at the same time that the parent bank in an extreme situation may decide to abandon its subsidiary, see Tschoegl (2003).<sup>10</sup> Thus, the situation is quite confused today as to who will actually assist a subsidiary in a crisis - if any.

### Crisis resolution in a branch

Crisis resolution should be more straightforward in a branch structure. The home supervisor is responsible for the whole group,<sup>11</sup> and the deposit insurance scheme covers all depositors, including foreign deposits.<sup>12</sup> A branch establishment is often used by cross-border banks dealing in wholesale markets, as the branch can then draw on the group's combined financial strength in its operations. Branches have so far been less common in other market segments and subsidiary structures continue to dominate cross-border banking.<sup>13</sup> However, recent EU legislation now paves the way for branch establishments and this has intensified the discussion about crisis resolution responsibilities in a branch structured cross-border bank, especially which role the host state authorities will have if a systemic branch gets into difficulties?<sup>14</sup>

The host-country authorities have generally little influence over crisis management in a branch bank. They may therefore be interested in gaining more influence and responsibility for crisis solutions affecting their branches, especially if the branch is large. In New Zealand, the authorities responded to this situation by instructing all systemically important branches in the country with total assets in excess of ten billion NZ dollars to re-establish as subsidiaries. A similar solution is not feasible in Europe, where the system is based on freedom of establishment and home-country

supervision of banks. A home authority can therefore in theory decide to close a host bank, without considerations for financial stability in that country. In practice, such decisions will be taken after close consultations between home and host authorities.<sup>15</sup>

CEBS (2005) has recently issued a consultation document with guidelines for home-host coordination. The home supervisor should communicate *essential information* to the host supervisor, if that information “could materially influence another Member State’s assessment of the financial soundness of a credit institution.” The home supervisor should in addition communicate other *relevant information* on request. This is a pragmatic approach to cross-border cooperation that could give the host supervisors a more substantial role in crisis resolution and enable them to contribute to an efficient crisis resolution. But increased involvement by host authorities in supervision and crisis resolution could also weaken the key role of the home authorities in crisis resolution and increase investors’ expectations of a host assisted bailout.

Nordea’s planned move to a branch structure has highlighted the difficulties in reaching cross-border agreements among the affected authorities. Since Nordea has a large market share in most of the Nordic countries, the host authorities have requested assurances that they will be actively involved in supervision and crisis resolution. So far no new agreements have been signed among the Nordic supervisors or central banks. Nordea’s planned transition to a branch structure has also been postponed until at least 2007.

#### Are cross-border banks “too-large-to-save”?

If the cross-border banking group is large in relation to its home country, the home country may be

<b>Bank equity capital in relation to home country GDP</b>		
	<b>Equity (book value)</b>	<b>Equity/GDP</b>
	<b>€ billion 2004</b>	
UBS	26,1	9,1
Credit Suisse	24,9	8,6
ABN	16,2	3,5
ING	15,7	3,4
Fortis	18,0	6,3
Dexia	11,5	4,0
Santander	40,9	4,9
Nordea	11,8	4,2

unwilling to support the foreign parts of the groups, should they require support. Dermine (2000) showed that the cost of a public bailout in some small countries (Belgium, the Netherlands and Switzerland) would be spread over a smaller tax base, thus putting these countries at a competitive disadvantage. Table 2 shows that the cost of a bailout could be relatively large in relation to GDP (Source: Bancscope).

If these financial groups are organized in a subsidiary structure, limited liability reduces the potential exposure of the parent bank and/or the home authorities. But the reputation risk of non-intervention could be damaging for the group as a whole, thus forcing the authorities hand in a public bailout. The home responsibility is even more direct in a branch structure, but the parent bank or the authorities would surely try to shoulder the fiscal burden with the host authorities. Nyberg (2003) thus notes that:

*According to current EU legislation, prudential supervision and crisis management would in principle be an issue for Swedish authorities. But would the Finnish authorities accept that Sweden takes responsibility for the most*



*important part of the Finnish financial system? And would we in Sweden be willing to resolve a banking crisis in Finland, with all that it would ask of the Swedish taxpayers, if Nordea were to run into difficulties? The answers to these questions are not straightforward.*

The Swedish Deposit Guarantee Board (2003) has also noted that ... “a possible solution (to the excessive burden on the home scheme) could be to revise the deposit guarantee directive and put more of the financing burden for host depositors on the host guarantee scheme.” The European Deposit Guarantee Scheme is currently under review, partly to address some of these issues, but a change in responsibilities along the lines suggested above seems unlikely.

Where does this leave us with regard to crisis resolution responsibility? Norges Bank’s view is that financial difficulties in a foreign-owned bank should be resolved by the parent bank and if required be supported by the home country authorities. The home authorities may not necessarily share this view, as they may be reluctant or unwilling to support a rescue of the host bank, especially if the resolution costs are high. If the bank is large in the home country, the authorities may even be unable to support the bank, should a crisis occur.

**Home country's position on public support for a large cross border bank**

**STRUCTURE**

Subsidiary	reluctant
Branch	unwilling
Small home country	unable

The roles and responsibilities for crisis resolution are therefore rather fluid at the moment. Is this bad for market discipline? Not necessarily so, if investors hold “true” forbearance expectations in the face of this uncertainty. But can we really expect them to see through this cloud of “resolution ambiguity” and price “correctly”? Not very likely, if they have adaptive expectations and recall how the last banking crises were resolved.

Hanweck et al. (2002) indeed show that “lengthy forbearance expectations still seem to prevail, despite a legislative mandate to the contrary.”

**WHO WILL PROVIDE LLR TO A CROSS-BORDER BANK?**

Much of the “home-host” discussions have so far primarily dealt with the division of responsibilities between national supervisory authorities. There has so far been less discussion about the division of labor between central banks in liquidity provision to a cross-border bank in financial difficulties. This is strange, given that it is only central banks (or the national treasuries) that can provide funds to resolve a cross border banking crisis. However, this is a delicate field and the prospects of getting central banks to agree on home-host principles for liquidity provision seem remote. Central bank lender-of-last-resort (LLR) policies vary so much, from those that have published their policies, like the Bank of Canada (2004), Norges Bank (2004) and Riksbanken (2003a), to those central banks that do not have an official LLR view or simply rely on “constructive ambiguity”.

Johnston et. al (2003) observed that there were different views on LLR policies among the Nordic central banks, and they recommended that the authorities should “seek a greater cross-border harmonization of approaches to distinguishing between liquidity and solvency problems, as well as to the implementation of ELA.”

This advice is in line with the classic policy for emergency liquidity assistance advocated by Bagehot, that central banks should provide unlimited liquidity against good collateral in a crisis. However, if the risk of liquidity provision is thus lowered, why cannot central banks agree on cross-border liquidity provision? The answer is obvious; the distinction between solvency and liquidity is hard to define, especially in a crisis, and as a consequence most LLR operations will be fraught with credit risk, see Clarke (2005). This is also why emergency liquidity provision to a large cross-border bank is unlikely without some involvement of the Treasury; see Goodhart (2005) and Huertas (2005). But negotiating burden sharing between national Treasuries in the midst of a banking crisis is not likely to be quick process. The risk is that politicians could be faced with bailout as the only viable policy option to avoid a cross border systemic banking crisis.

On the other hand, the politicians or authorities may be reluctant (or prohibited) to risk taxpayers' money to guarantee stability for a failing bank in another country. A possible "solution" could be to limit assistance to those banks affected by the failed bank. This solution has actually been advocated by the Riksbank (2003a):<sup>16</sup>

*One important consequence of the conclusion that not even one of the major banks is always important in itself for the functioning of the financial system is that one of these banks can be declared bankrupt if the potential contagion risks can be managed. On condition that a bankruptcy would only give rise to contagion effects in the form of liquidity problems, the Riksbank can manage these by providing ELA to other banks affected by the failing bank's payment default. In this way the functioning of the financial system can be maintained.*

But if the home central bank were to follow such an LLR policy, would it not weaken the home supervisors leading role in crisis resolution?

#### CAN THE AUTHORITIES CREDIBLY COMMIT TO A NO-BAILOUT POLICY?

Market discipline would clearly be strengthened if the home authorities could commit to a no-bailout policy in cross border banks. But such a hard commitment is not credible if the banks can be struck by common macroeconomic shocks, like recessions, asset market crashes and the like. Such fixed policy rules may then break down, even if the authorities would like to disengage. A policy of no-bailout may even be less feasible if the crisis erupts suddenly and spreads rapidly.

Rochet (2004) suggests that the government's commitment problem could be resolved by an independent supervisor, in combination with a rule that would reserve liquidity loans to banks with low exposure to systematic macro risk. However, the question remains what the authorities would do if a cross-border bank with large macro exposures actually failed.

The cost of non-intervention, i.e. the impact on the real economy, will be a key variable when the government reviews various resolution options. But as policy makers are well aware, this is a difficult variable to quantify. Nevertheless, the decisions by deposit insurers and central banks should in principle be based on such calculations. In the recent review of Norges Bank's lender of last resort policies, our board thus stated that emergency liquidity assistance "should be restricted to situations where financial stability may be threatened if such support is not provided"; see Norges Bank (2004).

If estimates of the economic costs of a banking crisis are hard to compile during a crisis, they are no easier to calculate after the crisis. Estimates for the economic cost of the Norwegian banking

crisis in the 1990s vary between 7 and 27 percent of GDP, depending on the methodology used; see Moe, Vale and Solheim (2004). We concluded that “it is necessary to explore different methods of output loss estimation in order to see how robust the estimates to changes in methodology are.” In practice, the decision to intervene in a crisis will be taken on the basis of the best available data “there-and-then”, with a potential bias in favor of intervention due to the fear of systemic contagion.

Kane (2005a) has been concerned about this bias in favor of public intervention and has suggested that standstills could be employed during a crisis “to allow government forensic analysts and private auditors to assess the depth and character of troubled bank’s wounds”. This would enable the government to sort out the good banks from the bad (“hopelessly insolvent zombie institutions”) and eliminate the need for blanket guarantees. Others have pointed out that such standstills are unrealistic in today’s electronic around-the-world trading environment, and that authorities can not even hope to get a week-end to sort out an acute banking crisis.

This is an empirical question. Experience from Argentine would suggest that the economic fallout of a prolonged banking holiday was indeed large, while experience from Sweden indicates that a developed economy could manage without banking services for some time.<sup>17</sup> However, many would hold the view that government intervention is almost inevitable if a banking crisis becomes systemic. But “systemic” is a vague term that can easily be used as an excuse for government intervention. The challenge is obviously to avoid the temptation of (too) early an intervention.

Pre-commitment to non-intervention will always be problematic in a world with intrinsic uncertainty, see Kohn (2005). Faced with a sudden crisis in a large cross-border bank, the authorities will have to improvise in uncharted territory. Somehow we need to take account of this “fact of life” in the more ruled based approach to crisis management. At the same time, the authorities should be able to increase the credibility of a no-bailout policy by continuing their work on risk proofing of the financial infrastructure, see Huertas (2005). This would include reviews of concentration risk and back-up and outsourcing policies. The question is whether a policy of no-bailout can be a credible policy if only one or two large banks dominate the domestic banking market?

## PRECONDITIONS FOR MARKET DISCIPLINE TO SUCCEED

Shareholders have been exposed to losses in many recent banking crises. Non-insured creditors have not been so much exposed. Investors have high forbearance expectations based on past experience. Crisis resolution methods involving blanket guarantees have reinforced such expectations; see Kane (2005b). Ingves (2005) has argued that such guarantees may sometimes be required in a force majeure situation to prevent a “financial meltdown.” The obvious response is to avoid situations where such policies have to be considered. Thus, both Ingves and Kane agree that we should work harder to reduce the likelihood of a systemic crisis (PD) or reduce the cost of a crisis (LGD) – should it occur. Only by reducing the potential negative impact on the real economy can the authorities credibly adhere to a policy on non-intervention.

Recent policy initiatives have explored ways to involve all creditor groups in a bank resolution strategy. They should provide better incentives for investors and thereby lessen the fiscal burden of a bank restructuring operation. The bank creditor recapitalization (BCR) initiative by the Reserve Bank of New Zealand is an innovative scheme that aims for a rapid crisis solution with uniform hair-cuts; see White and Ledingham (2005). Mayes, Halme and Liuksila (2001) have proposed something similar, with the authorities stepping in and distributing the losses across

creditors in order to re-open the bank quickly for business without any material interruption in trading.

These initiatives are interesting and point in the right direction. However, if they were applied to large cross-border banks, issues of different bankruptcy laws and burden sharing between different jurisdictions could topple an otherwise efficient crisis resolution model. As Goodhart (2005) observes "... if it is difficult to allocate burden sharing when losses have been suffered internally within a country, it will be many times more difficult to do so internationally".

The development of a new crisis resolution model should therefore be supplemented by other measures that will both reduce the likelihood of a crisis or reduce the cost of a crisis:

- **Large cross-border banks should be required to hold ample capital**, reflecting the large perceived negative externalities associated with a failure in such a bank. The "Swiss finish" is an interesting example of this policy: The Swiss authorities hold that banks in Switzerland are not over-capitalized, even with a capital adequacy that is 20-50% above the Basel requirements (see Zuberbühler, 2004).
- **The parent bank's commitment and funding strategy for the rest of the cross-border group should be clearly spelled out**, as part of its disclosure policy, ref. Pillar 3. This would reduce the scope for parent "constructive ambiguity", especially regarding its responsibility for liquidity to overseas subsidiaries in a crisis. The parent bank could also pre-commit lines-of-credit to alleviate the need for official emergency assistance.
- **Large cross-border banks could contribute to a joint ("insurance") fund** that would act as an international, private safety net in the event of a serious financial crisis. Such a fund could provide support to a cross-border systemically important bank, much like the pooling arrangements that have been established for the UK payment system, BoE (2003).
- **National deposit insurance schemes need to be realistically funded with risk-based premiums**. If home schemes cover large groups of overseas depositors, this needs to be officially acknowledged and the potential liabilities to the home taxpayers spelled out clearly. Then at least the country's taxpayers would be aware of the liabilities facing them, see Nyberg (2005).
- **Deposit insurance coverage could be lowered for large cross-border banks** to reduce the scope for free-riding on the official safety net. There is a widespread perception that large cross border banks pursue scale in order to become TBTF, see Kane (2000). To counter this incentive, a system of co-insurance could also be introduced. A more radical proposal would be to limit insured deposit taking in these banking groups to "narrow bank" affiliates, see Wilmarth jr. (2002).
- **National financial infrastructures should be further risk-proofed** to reduce the negative effects of a failure in a large cross-border bank. Great progress has already been made in reducing systemic risk in national and international payment systems, see Huertas (2005). However, some large banks hold market shares that make them almost "too-big-to-fail". Hüpkens (2005) suggests that national authorities should adopt a functional approach and try to protect only the functions that are systemically important.

## HOW TO HARNESS MARKET DISCIPLINE IN CROSS-BORDER BANKING

To sum up, market discipline can only work if stakeholders are exposed to losses if a bank fails. But investors seem to hold strong forbearance expectations, despite legislative mandates to the contrary. The expansion of cross border banks continues, even though the synergies are hard to detect, see Nicoló et al. (2004). This has led to a concern that cross-border banks are reaching for size to qualify for safety net subsidies. However, many cross-border banks have outgrown their national jurisdictions and should rather be considered as “too-big-to-save”.

If crisis resolution in a large cross-border bank is too large to handle for the authorities in one country, the natural response would be to arrange a multi-country burden sharing. But, as Goodhart (2004) has observed: “There is no mechanism in place to devise a generally acceptable sharing of burdens from international (banking) crises ... Can we rely on voluntary co-operation and co-ordination between the countries involved under such crisis circumstances? Frankly I am doubtful.”

A coordinated resolution could perhaps work if only a few countries were affected, but crisis resolution exercises have shown that even this can be hard to achieve. It is not obvious that tax-payers in one country will be happy to bail out the banks of other countries. Thus, as Gros (2003) observed “...the first step the authorities should discuss when a bank crisis arises is how to arrive at good private solutions.”

If a crisis comes quickly, there will inevitably be strong pressure for official intervention and liquidity support by central banks. To avoid a “blackmail” situation, authorities need to strengthen their early-warning capabilities and take prompt corrective action to avoid such situations in the first place. But most importantly, they need to take steps to make a no-bailout policy credible. Only then can market discipline be relied upon to harness the expansion of cross-border banks.

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<sup>1</sup> The term “cross-border banking” will be used here to encompass bank’s establishments abroad as either branches or subsidiaries; i.e. other representation forms such as direct cross-border lending or lending via a representative office are excluded. Why banks choose to establish overseas offices, or why they choose a specific representation form is not discussed further. See Dermine (2002) for a discussion of these issues.

<sup>2</sup> Basel Committee Consultative Document, January 2001, para. 7.

<sup>3</sup> Hanweck et al. (2005) shows that strong forbearance expectations could cancel out the disciplining effect of a mandatory subordinated debt rule.

<sup>4</sup> For a broader discussion of this issue, see Borchgrevink and Moe (2004).

<sup>5</sup> This principle was adhered to during the Norwegian banking crisis in the early 1990s, when the share capital was written down to zero before the Government committed new funds, Moe (2004).

<sup>6</sup> See for example Lastra (2003) and Herring (2004).

<sup>7</sup> We use the term “host” here to encompass both “branch host” and “subsidiary host”. Since a subsidiary is in fact licensed and supervised in the host country, it has previously been common to designate this country as the “home” country for the bank. There has recently been a shift towards the term “subsidiary host”, reflecting the de facto shift in responsibilities that has taken place.

<sup>8</sup> See IMF (2004) for an interesting discussion of measures to counter such a development.

<sup>9</sup> The Australian subsidiaries are in fact previous branches that were considered to be systemic by the RBNZ, and the new regulation then required them to incorporate in NZ.

<sup>10</sup> Tschoegl (2004) describes the limited liability of the parent bank as “an option to abandon with the strike price being the loss of reputation if it walks away”. Hüpkes also (2003) discusses the likelihood of parental support, p. 31.

<sup>11</sup> The host supervisor retains formally some responsibility for liquidity supervision, but this function is in practice often left to the home supervisor.

<sup>12</sup> With the well-known exceptions of US and Australia, where *depositor preferences* gives national depositors preference treatment.

<sup>13</sup> For a discussion of why banks choose branch or subsidiary structure, see Dermine (2000) and Huizinga (2003).

<sup>14</sup> Freixas (2003) shows that the home-country authorities do not have the incentives to contribute to an optimal crisis solution if only host countries are affected. However, Calzolari and Loranth (2005) find, in another model, that the incentives to monitor are maximal with a branch structure, as the home bank is more affected by failures in the host branches than with a subsidiary structure.

<sup>15</sup> Several new member states in EU have banking sectors that are dominated by foreign banks, often branches. These countries have been vocal in getting the home-host coordination issue on the agenda in CEBS.

<sup>16</sup> See also Rochet and Tirole (1996) for an early argument along these lines.

<sup>17</sup> A labor dispute led to a week long bank holiday in the late 1990s. There were no reports of major difficulties, although it should be noted that the non-availability in banking services were known in advance.



