

Mayes, David; Vesala, Jukka

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20/98

David Mayes – Jukka Vesala

Research Department
23.9.1998

On the Problems of Home Country Control

Suomen Pankki
Bank of Finland
P.O.Box 160, FIN-00101 HELSINKI, Finland
☎ + 358 9 1831

David Mayes – Jukka Vesala

Research Department

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The views expressed are those of the authors and do not necessarily correspond to the views of the Bank of Finland

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On the Problems of Home Country Control

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David Mayes – Jukka Vesala
Research Department

Abstract

In the European Economic Area the home country supervises the activities of its banks, wherever they are operating via branches or across borders, while the host country handles the stability of its financial system and problems stemming from failure or distress. We address two main problems related to the conduct and co-ordination of these two responsibilities. First, the introduction of the euro and the removal of other regulatory barriers is likely to lead to increasing internationalization of banking. In particular in smaller countries, large portions of the banking sector may be supervised by other 'home' authorities. This will make difficult assessing what is happening in the market as a whole and warning about emerging systemic problems. Home supervisors will find it difficult to cover the widening range of countries in which their banks operate. Increasing the information exchanged and co-operation among supervisors would be helpful, but emphasizing public disclosure by banks to enable market discipline to supplement the work of the authorities would help overcome the problem of information considerably, in addition to the favourable impact on incentives to banks for prudent risk management. Second, the interests of home and host supervisors in a crisis may differ and need to be co-ordinated. What is important to the host authority in a small country may be inconsequential to the home supervisor of a multinational bank in a large country. Co-ordination at European level might help.

Keywords: banking supervision, disclosure, crisis management

Kotivaltion kontrollin ongelmat pankkivalvonnassa

Suomen Pankin keskustelualoitteita 20/98

David Mayes – Jukka Vesala
Tutkimusosasto

Tiivistelmä

Euroopan talousalueella kotivaltion valvontaviranomainen vastaa pankkivalvonnasta, sikäli kuin kyseessä on toiminta sivukonttoreiden kautta tai etäpalvelujen tarjonta. Kohdevaltion viranomaisilla on kuitenkin vastuu oman rahoitusjärjestelmän toimivuudesta ja vakaudesta sekä mahdollisten pankkiongelmien seurausvaikutuksista. Tässä työssä tarkastellaan näiden tehtävien koordinointiin liittyviä ongelmia.

Ensiksikin on mahdollista, että yhteisvaluutan myötä pankkitoiminta kansainvälistyy Euroopassa huomattavasti. Erityisesti pienissä maissa pankkitoiminnasta voivat vastata enenevässä määrin ulkomaalaisomisteiset pankit, joiden valvonnasta vastaavat niiden kotivaltion viranomaiset. Tämä vaikeuttaisi pankkimarkkinoiden valvontaa ja seurantaa sekä uhkaavien epävakaustekijöiden havaitsemista ennalta. Kotivaltion viranomaisten valvontataakka kasvaisi luonnollisesti huomattavasti. Tietojenvaihdon ja viranomaisyhteistyön lisääminen yli maiden rajojen helpottaisi ongelmaa, mutta pankkien riskejä ja riskienhallintaa kuvaavien tietojen julkistamisen lisääminen tukisi markkinoiden kautta tapahtuvaa valvontaa viranomaisvalvonnan lisäksi ja johtaisi parempaan lopputulokseen. Toiseksi pankkiongelmien ja -kriisien hallinnassa tultaisiin tarvitsemaan pitkälle menevää koordinaatiota viranomaisten välillä. Ongelmallista olisi erityisesti se, että eri maiden viranomaisten intressit voivat olla erilaiset. Koordinaatio Euroopan tasolla pienentäisi tätä huolta.

Asiasanat: pankkivalvonta, markkinainformaatio, kriisinhallinta

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1 Introduction

It is the responsibility of the home country to supervise the activities of its banks, wherever they are operating via branches or remote supply across borders within the European Economic Area (EEA).¹ It is the responsibility of the host country to deal with the stability of its financial system and problems stemming from failure or distress. In this paper, we address problems related to conduct and co-ordination of these two responsibilities.

The introduction of the euro may increase the incentive for cross-border merger and the supply of services across borders to the point where smaller countries, in particular, find that significant parts of the banking activities for their residents are no longer directly supervised by their own authorities. In these circumstances the responsibility of home authorities in conducting efficient consolidated supervision would increase considerably. Moreover, host supervisors could find that they have insufficient information either to monitor the health of the financial system to anticipate a crisis as well as they might or to be able to react to it as rapidly and effectively as they might. Up till now the extent of this problem has been limited as the large majority of the banking systems are domestically controlled.

We discuss three responses in the paper. One response would be to encourage the exchange of information and co-operation among supervisors further in a way that makes the best use of the 'comparative advantages' of the authorities involved. It is the efficient exchange of information that is the main purpose of the Memoranda of Understanding (MoU) that have already been signed bilaterally between many supervisory authorities². There are potentially difficult incentive issues, especially related to co-ordination in a crisis, that need to be resolved if this mechanism is to be efficient. Secondly, one might consider strengthening the role of the host authorities while, nevertheless, maintaining the principle of home country control and thus allowing cross-border activity to develop without unnecessary bureaucratic barriers. The host's contribution is especially valuable in assessing whether banks' problems are systemic (industry-wide) or idiosyncratic, which is a key consideration when choosing the appropriate supervisory action. However, a third suggestion, which we espouse, is that the appropriate response should in any case seek to strengthen market discipline. Wider public disclosure by banks, so that all those potentially affected by banks' cross border activities, be they supervisors, customers, creditors or taxpayers can be informed of the risks they face, would both encourage prudent behaviour in general and alleviate the specific concerns over home country control identified here.

In the sections that follow we consider briefly, first, why we see potential for expanded cross-border activity, before going on, in Section 3, to review the overall elements of an efficient supervision regime. We then analyse the specific

¹ We concern ourselves only with issues of prudential supervision. Consumer protection and other aspects of regulation lie beyond the scope of this paper.

² Within the EU, bilateral agreements between national supervisory authorities ('Memoranda of Understanding', MoU) concerning the exchange of information and the organizational aspects of co-operation have emerged after the implementation of the home country principle (Second Banking Co-ordination Directive). MoUs also seem likely to be the main tool of bilateral co-operation also in the future. There are also multilateral arrangements to discuss issues of mutual interest such as the Banking Supervisory Committee in the ESCB.

concerns relating to: the efficiency of ongoing banking supervision and monitoring financial system health (Section 4); the role of disclosure (Section 5); and handling banking problems (Section 6). We focus on the concerns that surface when a substantial part of banking activities in a country are conducted by foreign-owned institutions; a situation that will emerge if international banking consolidation gathers pace.

2 The internationalization of banking in the euro area

As the integration of the European market for financial services has increased so analysts have expected a consolidation of banks and other financial institutions both within the borders of the states of the EEA and across those borders. We have already seen a wave of consolidation within domestic banking industries, which has significantly increased banking concentration particularly in smaller European countries (Austria, Belgium, Denmark, Finland, the Netherlands, Norway and Sweden). However, cross-border mergers or acquisitions between large universal banks still seem to be the exception rather than the rule, though things have started to change. Further consolidation would have to involve an international dimension in countries where further reduction in the number of major banks would be questioned by the competition authorities.

There are other factors likely to encourage international consolidation in the years to come. Firstly, cross-border deals may be struck to achieve 'critical mass' for euro-denominated wholesale markets, which seem to exhibit significant economies of scale. Banks will need to process not just national financial market information but euro area-wide information. Secondly, the introduction of the euro will lower the barriers to entry into national banking markets yet further. In Stage Three foreign entrants no longer will need to use local currencies. They can fund their lending in euro from their domestic retail deposit base or from European money and capital markets. It will become easier and cheaper to conduct foreign businesses. Cross-border mergers or acquisitions would be the fastest way to acquire local expertise and customers. Although transnational operations are also traditionally a means of diversifying risk, the power of this incentive will probably fall as the EU economies become more integrated.

Since econometric studies have not typically found significant evidence of overall economies of scale in banking (at the company level), some have argued that national consolidation has occurred because of banks' desire to strengthen market position and monopoly power. However, the recent comprehensive European study by Vennet (1996) concludes that in cases of large-scale domestic mergers of equal partners the major source of performance improvement has been through the reduction of costs, by elimination of duplication and exploitation of synergies (efficiency improvement) and also to some extent through economies of scale.³ This has improved the competitive viability of the banks involved. The efficiency improvement motive for merger might continue to prevail but

³ Calomiris and Karceski (1998) provide strong methodological criticisms of estimates of the gains from mergers that are based on econometric cost/profit functions or on stock market data, primarily because the time horizon is too short. They present case-study evidence from the US that mergers have increased efficiency and produced customer benefits.

continuing improvements in information technology and the move to the euro may well increase the importance of the overall scale economies, not just in wholesale activities.⁴ The traditional results may underestimate the scale economies as they do not often include the more up to date data nor the full consequences of recent IT developments and substitution of automation for labour in banking.

Up till now retail banking has remained largely in the hands of national banking organisations perhaps in part because legal and cultural factors and differences in payment systems constitute barriers to entry. Different conduct of business standards applicable in each domestic market also tend to encourage separation. Since the savings in direct costs from eliminating overlaps in the retail network (potential efficiency improvement) are likely to be limited and the managerial costs involved substantial, even with a single currency, the likelihood of cross-border mergers and acquisitions that are motivated by the access to local retail markets may still be low. At least this may be true in the short term, as the effects of the euro on retail markets is likely to be slower than on their wholesale counterparts.

Where cross-border mergers have taken place, the national operations have often remained separate – what Matthews and Mayes (1993) describe as the ‘multi-domestic’ as opposed to the multinational approach to organizational growth. In Europe, corporate law seems to have supported this kind of structure, since merging two banks across borders would require the termination of one or both components and consolidation of assets, which would not be attractive to strong banks. There are prospects for the creation of an ‘European corporation’ through a Community Regulation that could abolish this problem and probably boost cross-border consolidation significantly. Moreover, the likely result of mergers and acquisitions could then be fully integrated banking firms (including retail banking) that operate through branches in different countries, since branching seems to be more cost efficient than establishing or maintaining subsidiaries in the Single Market. In this case the supervisory concerns we highlight in this paper would be greatest.

Establishing a single branch or a small number of branches in foreign countries could also be sufficient to attract customers when they are served through modern techniques, like phone- and PC- banking (also called ‘direct’ banking). There are also prospects for increased remote supply,⁵ without establishment at all, using direct banking methods. The euro could constitute a significant catalyst for such investment, as the effective market size expands. Direct cross-border banking from other countries, like the development of direct insurance and some other financial services, will be progressive and could develop rapidly. The Internet (email) adds to the opportunities available over the telephone. To some extent, remote supply could be an alternative to cross-border mergers and acquisitions.

⁴ Studies using more recent data tend to point to larger scale economies than before. Berger and Mester (1997) attribute this to technological change. IT development increases scale economies, because it increases the share of fixed and investment costs and reduces that of variable per transaction costs in the overall banking costs.

⁵ ‘So-called’, because the source of that supply, from another member state, may actually be closer to the customer than many sources within the same state.

There is naturally much uncertainty surrounding future banking structures, since only the time will show how banks respond strategically.⁶ One of the strongest possibilities is that multinational banks or financial conglomerates will acquire important positions in the smaller European markets. Banks that are big by local standards and have a strong niche in their national currency-denominated markets but are small by European standards could be badly placed to cope with changes brought about by the introduction of the euro and be forced to adjust. The recent Merita-Nordbanken merger of the largest Finnish bank with the third largest Swedish is an obvious example of the sort of response that can take place.

Although there will no doubt continue to be roles for banks of all sizes and ranges of facilities to play, the creation of any cross-border entity that controls a substantial proportion of a host country market, yet is supervised by a different home country, provides a challenge that must be addressed. Such an outcome is by no means impossible. All the significant banks are foreign owned in New Zealand. While it remains to be seen whether the introduction of the euro is the key change that triggers the creation of many such institutions, supervisors need to be alert to the prospect.

3 Elements of an efficient supervision regime

In the introduction we highlighted our concerns for adequate information to monitor the ongoing health of the financial system and resolve and indeed preempt crises under the principle of home country control. However, to understand the context of these issues we need to have a clear overall view of what is required of a successful supervision regime that encourages prudent behaviour.⁷ Following the generally accepted principles (see Goodhart et al, 1998, for example) the main ingredients of such a regime also include a third requirement and are

⁶ According to Boot et al (1998), managers' incentives to engage in consolidation can be related to either building managers' own reputation (bad motive) or obtaining skills and other possibilities for competing efficiently in future market conditions (good motive). They show that managers' incentives to conduct 'skills-enhancing' deals are greatest when competition in banks' present activities is moderate, but keen future competition is expected. On these grounds growth in mergers and acquisitions in European banking can be expected with the introduction of the euro.

⁷ It is implicit that systemic stability of banking deserves special public attention in contrast to other sectors of the economy. The main justifications in the academic literature are: (1) Occasionally public action may be required when a solvent bank encounters a liquidity problem (even without any question over asset quality) due to the illiquidity of its assets (Diamond and Dybvig 1983) and private information embedded in the asset values. (2) Bank failures can lead to systemic crises through the breakdown of the payment systems or possible contagion of problems to other institutions. Even a small probability can imply a large expected loss to the economy (Greenbaum 1995). (3) Safety nets (deposit insurance, lender-of-last resort, payment system guarantees) can help avoid banking panics due to liquidity problems, but the existence of the safety net can itself create the moral hazard of excessive risk taking. In some respects it is this last risk, that consumer protection itself may lead to excessive risk taking, which provides the basic motive for prudential regulation and supervision (Baltensberger and Derimine 1989, Greenbaum 1995). The other two motives entail that the authorities need prior information on the banks that may be at risk so that they can act swiftly and effectively. They may also feel that they wish to set minimum standards so as to reduce the risk. There are contrasting views. Benston and Kaufman (1995) argue that that there is little theoretical or empirical evidence that banking is inherently unstable.

- 1 careful control of the right of establishment as a bank,
- 2 a system of supervision substantially complemented by market discipline stemming from public disclosure,
- 3 an efficient system of handling banking problems and crisis management.

These three 'pillars' have to coexist if the regime is to fulfil its task efficiently and need to be supported by regulations on licensing requirements, prudential standards, disclosure requirements, safety net provisions, and accounting and audit standards. The supervision regime involves monitoring that the regulations are obeyed, observing the behaviour and exposures of institutions, and taking care of problem situations in a predetermined manner.

Without exercising entry control it is difficult to have a proactive approach to supervision to ensure that banking activities are conducted by institutions that have capable management, incentives to prudence and adequate internal controls in place and in operation. It is also needed to ensure that company structures and operations are and remain transparent to markets and supervisors. Common rules to achieve this have been agreed and implemented in the EEA (as discussed in the next section).

The most important part of the incentive structure embedded in an efficient supervisory regime is that all parties understand the possibility of difficulties or even failure associated with the risks inherent in banking. If shareholders (in choosing management and management control practices), managers (in managing risk) and uninsured creditors of banks (in choosing banks) feel themselves more at risk, both financially and for their reputations, they will tend to want to manage their risks prudently. Thus, public supervision and crisis management practices and safety net arrangements should be devised to support the contention that shareholders and uninsured depositors and other creditors will not be bailed out by tax payers' money.⁸

It is widely accepted that supervision would be best consistent with this incentive structure if systemic stability and confidence in the banking system as a whole, not the integrity of individual institutions, were the primary objective.⁹ While individual managements may be best suited to addressing the problems of their own businesses a supervisor with information on all the market participants is in a better position to point out market-wide trends that may threaten stability. Supervisors also need clear procedures and autonomy for handling breaches of prudential rules and other types of misconduct. Forbearance of banking problems

⁸ Mishkin (1998) argues that the most convincing way of giving a credible signal that individual banks will not be bailed out with tax payers' money is to commit to a strong presumption that the first bank to encounter difficulties will be allowed to fail and the costs of the failure would be borne by uninsured depositors and creditors. The authorities would be ready to extend safety net to the rest of the banking system, though still maintaining 'constructive ambiguity' of that extension, if there is a danger that otherwise the stability of the banking system would be threatened. Application of this method would naturally be complicated in banking systems that are clearly perceived to contain institutions that are 'too-large-to-fail'.

⁹ One of the key premises set out in the 'Core Principles for Effective Banking supervision' of the Basle Committee on Banking Supervision (1997) is that supervision should not try to support the perception that banks do not fail and support the integrity of all institutions. Section I of the 'Principles' states that 'the key objective of supervision is to maintain stability', and that 'supervision cannot, and should not provide assurance that banks will not fail'.

through adjustment in the interpretation of rules, or hesitation in supervisory reactions is likely to aggravate the existing problems and induce moral hazard.¹⁰

Vigilant supervision by a public sector agency is merited by the high social costs associated with the systemic banking problems. Concerns will always be greatest in periods of structural change, as at present, with banks having to adjust to the more integrated and competitive markets occasioned by the introduction of the euro. As pointed out by Estrella, 1995, *inter alia*, prudential supervision needs to cover behaviour and cannot merely rely on limits such as capital adequacy. New markets and instruments have made it possible for banks (or their individual employees) to make easily and quickly huge bets that may drive a bank into insolvency.

The response of supervisors has already been to put more emphasis on the supervision of institutions' internal control mechanisms and practices, since innovation, internationalization and increasing complexity of businesses make it increasingly hard for supervisory authorities to keep track of the risk exposures of individual institutions continuously. For this reason, there is also substantial support for putting more emphasis on public disclosure and forces of market discipline and corporate governance in order to strengthen the overall supervision regime.¹¹ That is, supervision not just by authorities but also by banks' clients (other financial institutions, firms and private customers) and shareholders. The precondition is that these parties are not insulated from losses in case of failure.

Increased transparency through public disclosure of information is thought to be most influential with respect to the enhancement of market discipline. The goal of disclosure from the supervisory perspective is to improve bank managers' incentives for prudent risk taking and thus reduce the probability of failure. Cordella and Yeyati (1998) show that this indeed occurs when risk taking is largely idiosyncratic and a bank can choose its portfolio risk. But when risks are largely exogenously given and the risk level of the banking system fluctuates within a wide range, disclosure of information increases the probability of bank failure. Our interpretation of recent banking problems is that idiosyncratic risk taking has played an important role. For example, in the banking crises of Finland, Norway and Sweden, where the operation of the entire banking system was threatened, some banks actually managed to get through the crisis without major losses.

The analysis by Cordella and Yeyati implies that increasing disclosure is likely to produce the desired result in strong and developed banking systems.

¹⁰ Forbearance is one of the core problems of supervision due to the embedded time inconsistency problem (Goodhart, 1995). Even if authorities announce in advance that they will deal severely with banks that breach supervisory standards, they may fail to behave in this manner when the time comes. When the event happens a strong response may be judged inappropriate due to the fear of weakening the condition of the institution in question further. The supervised institutions would anticipate this forbearance and factor it into their own decisions. For this reason, precommitment and strict rules for the supervisors are recommended. When there are problems across all institutions Goodhart argues that discretionary supervisory behaviour could be justified to reduce the threat of a systemic crisis.

¹¹ For example, the G30 has suggested, *inter alia*, improving market discipline through disclosure as a response to weakened possibilities for supervisory agency control of complex internationalized organizations. Moreover, the 'Principles' of the Basle Committee on Banking Supervision (1997) state in the introductory Section I that 'Supervisors should encourage and pursue market discipline by encouraging good corporate governance ... and enhancing market transparency and surveillance'.

Opportunities for banks to hedge risks would also support this outcome. In these conditions disclosure can reduce the opaqueness of banks' asset values and thus reduce the negative effects of asymmetric information between banks and their clients. As with any change in regulation, the introduction of a greater emphasis on public disclosure should be timed in a period of financial system health so that the chance of unwelcome shocks to the market from what is revealed is limited.

Markets (credit rating agencies, counterparties, depositors and other creditors) can be expected to anticipate problems to some extent, and react accordingly when there is accurate and timely information. However to our view, the major mechanism actually generating the incentives for prudence is the requirement to disclose problems quickly after they have emerged, which would expose banks to the possibility of adverse market reactions. Counterparties' and creditors' reactions are more likely to be 'exit' than 'voice' (public announcement of their judgement) to protect their own receivables, but this would affect the cost of borrowing and impose discipline indirectly. The threat of adverse market reactions increases the accountability of the managers, and makes them subject to reputational penalties,¹² which encourages them to be well informed about the activities and risks of their organization. For example, one would expect that management would be more inclined to have an independent audit committee.

Sufficient penalties are needed to enforce the mechanism in the case of a prolonged disclosure of problems (which tends to aggravate difficulties) or misleading information. If there were any attempt at deliberate obscuration of information, supervisory action against the bank and the managers in question would be called for.

Emphasising market discipline should not be viewed as washing one's hands of supervision in an increasingly complex world, but rather as an attempt to provide a supervision regime that increases the chance of prudential behaviour. The most important benefit of this approach to the supervisors is that they could concentrate more on the functions where they have clear advantages:

- 1 assessing entrants' management quality and transparency of company structures (ensuring proactive supervision),
- 2 identifying potential problems which relate to the banking system as a whole (eg exposure to particular markets or sectors) and focusing on potentially fragile institutions,
- 3 prompting early corrective action or resolution of banking problems and ensuring that crisis resolution capabilities (contingency plans) are in good shape,
- 4 ensuring that institutions comply with the disclosure requirements and providing relevant advice.

An additional advantage of effective disclosure is that it reduces the threat of supervisory arbitrage, ie relocation of activities into jurisdictions where the

¹² By having these reputational penalties and encouraging a regime which makes early identification of problems more likely it is hoped to provide at least some safeguard against 'go for broke' strategies (Kupiec and O'Brien 1995). The worry is that managers, having breached the criteria for prudence have no greater downside penalty from following increasingly risky strategies. In the New Zealand system that has taken the market discipline 'doctrine' quite a long way (Mayes 1997) the penalties for trying to cover up and get through a difficulty are intended to be greater than those from disclosing an impending problem in the first place.

supervisory standards and practices are looser.¹³ Under effective market discipline, placing oneself under a 'weaker' regime would have little impact on prudent behaviour and quality of service. Indeed the incentives might be heightened if the market chooses to penalise such a move. We return to more explicit treatment of disclosure in section 5.

4 Ongoing banking supervision and monitoring financial system health

General supervisory framework. The EU supervisory framework is based on the principle of home country control, which maintains that the competent supervisory authority of the home country, where the bank has received its licence, has the responsibility for the ongoing supervision of that institution. This responsibility covers the activities carried out by branches throughout the EU or by cross-border supply of services. If the establishment occurs via subsidiaries, the host authority is responsible for the supervision, since a subsidiary is a registered entity within the host country jurisdiction. Supervision of individual banks is complemented by the supervision on consolidated basis of groups of banks. Again, the home supervisor is responsible for the supervision on consolidated basis.¹⁴

A particular feature of the EU supervisory framework is that there is no separate licensing by the host authorities of branches of banks registered in other Member States. This 'single passport' was devised to support the creation of the Single Market and increase foreign competition and hence depth and efficiency of financial markets. This approach is viable, since the main body of prudential legislation has been harmonized in the EU and the supervisory practices are sufficiently similar to one another.

The current EU framework for prudential supervision will continue to apply in the Stage Three of EMU. The Statute of the ESCB/ECB permits NCBs to continue their supervisory duties or close co-operation with supervisory authorities.

According to the Core Principles for Effective Banking Supervision issued by the Basle Committee (on Banking Supervision) (1997), as the basic reference for supervisory authorities in all countries, the home supervisor must be in charge of the world-wide consolidated supervision of their international banks including overseas branches, subsidiaries and joint ventures. However, the thrust of the Principles is to support the role of host country supervision as well.¹⁵

¹³ The incentives would be weakened by any implicit or explicit government guarantees to banks.

¹⁴ The home country principle is stated in Article 13 of the Second Banking Co-ordination Directive, and the rules of consolidated supervision are stated in the Directives on the Supervision of Credit Institutions on a Consolidated Basis and on the Capital Adequacy of Investment Firms and Credit Institutions. The so-called BCCI-Directive, Article 3, stipulates that authorities shall require the bank (credit institution) registered in that country also to have its head office in the same country. The supervision of liquidity is an exception, since it is subject to host supervision.

¹⁵ This general principle is stated explicitly in the Basle Concordat, and the Core Principle 25 requires that '(host) supervisors must require the local operations of the foreign banks to be conducted by the same high standards as are required of domestic institutions'.

When a substantial part of banking activities are conducted by foreign-owned institutions ongoing supervision requires co-ordination. Within the scope of the general framework we have outlined, an efficient system would make the best use of the contributions and 'comparative advantages' of home and host supervisors. The accomplishment of this requires adequate and relevant information and sufficient incentives to all concerned authorities.

Contributions of home and host supervisors. There are strong arguments for organising supervision by functions and risks in contrast to the traditional institutional approach where different institutions with de facto similar functions may be supervised by different authorities (Merton, 1995; Wallis Committee, 1997; Goodhart et al, 1998). The functional approach has its own merits, like better guarantee of equal supervisory treatment of similar activities. However, there are also strong merits in having one authority in charge of monitoring the safety and soundness of entire institutions or groups, since the continuation of their business, and hence the systemic stability, hinges on the financial condition of the institutions as a whole. Prima facie therefore no single supervisor is likely to be able to handle all facts of prudential supervision efficiently.

When the bulk of the activities of the institutions are conducted domestically, the home authority has the least difficulty in carrying out consolidated supervision. Home authorities have typically developed intimate knowledge of their institutions and close contacts with their personnel. In these conditions, host country supervisors see only a limited part of the overall operations of the foreign institutions within their territories.¹⁶

The internationalization process, when it results in organizations having a substantial share or even majority of their operations in foreign countries, is almost bound to loosen these ties with their home supervisors. Moreover, with growing cross-border exposures, failures in foreign activities constitute an increasing threat for the solvency of the entire institution. However, this is not a one-sided issue. There is a clear benefit from internationalization for systemic stability, when it enhances the diversification of banks' risks and capability to withstand country-specific shocks such as economic downturns.

As a result of internationalization, home authorities' burden in getting and processing information for efficient consolidated supervision of the institutions for which they are responsible increases considerably, even if there are no specific obstacles to getting necessary information, as is the case within the EEA. Assuring timely corrective action can be quite hard. Banks' central management can have considerable problems in controlling foreign operations and supervisors are largely dependent on the second-hand information from the banks themselves. The lesson from the recent Barings, Daiwa incidents seems to be that the focus should be on the institutions' ability to produce and indeed use sufficient consolidated information for their own internal risk management purposes reasonably quickly (Goodhart, 1995). This information would then be disclosed to supervisors and markets. It would be the task of the home supervisor to ensure that banks complied with implementing and reporting on their risk management mechanisms in all their operations and not just those in the home country. Public

¹⁶ The 'Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments' issued by the Basle Committee (1992) states that 'if the host country authority determines that any of the standards (for efficient home country consolidated supervision) is not being met, it could impose restrictive measures or prohibit the establishment of banking offices'

disclosure should improve banks' incentives to invest in the respective risk management systems.

The informational requirements of efficient consolidated supervision are quite different when banks operate just in foreign securities markets and only conduct wholesale activities from when they engage in widespread commercial and private customer lending. The former has been so far the major cross-border activity for banks in Europe and market risks have dominated in banks' foreign exposures. Extension of the latter activities, and hence foreign credit risks, would increase the importance of being familiar with the local market conditions.

Indeed, the significant contribution of the host supervisors is the view of the trends and areas of growing risks within their financial systems (strategic risks) that can seriously affect all institutions operating in that system. The more weight is put on the systematic assessment of the effects of the macroeconomic and sectoral developments¹⁷ on banks and on the industry-wide developments within the banking system such as asset quality, lending growth and competition, the more effective this contribution ('macroprudential supervision').

The supervisor responsible for such concerns needs to be well integrated with those involved with forward-looking assessments of the economy. Central banks or ministries of finance often provide such links. Deriving the view on the banking industry requires banks to produce information for supervisors in a manner that makes possible calculation of aggregate figures and comparisons across banks. 'Hands-on' knowledge and understanding of the local market conditions that cover the banks' business environment goes beyond the quantitative prudential supervisory returns on credit and market risks.

This kind of analysis would help supervisors to distinguish between idiosyncratic and systemic (industry-wide) banking problems, which is a fundamental consideration in choosing the appropriate supervisory action. Based on the arguments in Dewatripont and Tirole, 1994, ch.4 and Nagarajan and Sealey, 1995, supervisory actions would best provide incentives for prudent behaviour when they penalize problems caused by idiosyncratic individual management decisions more severely than those caused by adverse market movements out of management's control. The goal is to contain the idiosyncratic problems in a timely manner before the spillover effects could jeopardize the stability of the banking system.

Idiosyncratic 'misbehaviour' can be two-fold. Institutions may not respond promptly to economic and structural developments or financial market events (lack of effort), or they may engage actively in high-risk strategies. There have been clear cases of herding behaviour in banking, with many institutions having the same strategies at the same time. In these cases individual strategies may not necessarily entail excessive risk taking, but the joint effect may be heightened systemic fragility.

Early communication of this information and analytical results based on it is crucial. The home authorities in charge of the consolidated supervision need to be able to add up the effect from the different markets. While the host authorities need information on the exposures of the foreign banks within their territory if

¹⁷ Specific macroeconomic indicators that would be suited to the monitoring macroeconomic developments that could affect the financial system are detailed in Lindgren et al (1996) *inter alia*. They suggest credit market conditions, asset price and interest rate sustainability and volatility, corporate and household debt burden and credit servicing capabilities, government finances and external balance as typical areas to be followed with the help of specific indicators.

they are to contrast these exposures to those of the rest of the industry and inform the home authority of possible concerns (of idiosyncratic misbehaviour). Hence, unconstrained sharing of the information between the home and host supervisors would be useful. Furthermore, multilateral contacts with supervisors to assess regional or global trends affecting the banking industry should bring a significant value added to the supervisory process.

The issue we highlight here is that the host country may not be able to detect a problem properly unless the home country makes the information about activities in its market available. It is true that host authorities can get some information from foreign branches' direct reports for eg statistical purposes but host authorities' powers to impose reporting requirements are limited.

It appears to us that the MoUs, which have been signed thus far in the EEA, do not normally provide for the routine transfer of information among supervisors in the manner described but only in the case of suspected misconduct or other problems. A host cannot pass back helpful market-wide observations to the home country if it does not have data on the whole market.¹⁸ Here is a potential contrast between the needs of supervisors and the wishes of banks for public disclosure. Banks would expect to disclose on a consolidated basis only.

The same issue of 'detecting trends' and singling out 'idiosyncratic' problems arises in the context of supervising financial conglomerates. Namely, the supervisor that carries out consolidated supervision would benefit from information from the separate supervisory authorities responsible for particular sectors (eg insurance), concerning the specific developments within that sector.

Since the host authorities work in close contact with the local markets and have responsibilities for supervision of business conduct, they might receive information that indicates problems in the organizational structure, management competence, internal control or business practices and reputation that could be present elsewhere as well and jeopardizing the stability of the institution as a whole. These may be signs of the lack of the requisite expertise to conduct operations in foreign markets. The host authority should naturally communicate these signs to the home supervisor, as stipulated in MoUs.

With public disclosure the problem of what confidential information to communicate to other supervisors about individual banks is considerably reduced as supervisors have much less private information. Communications would then be more in terms of qualitative assessments and interpretations of the data.

Proactive adjustment of public supervision. Perhaps the most important precondition for efficient consolidated supervision is that the company structures are always transparent and that no part of the organisation is omitted because it lies 'between' or outside the jurisdictions involved. The global structures should not be beyond reach and the internal controls and public supervision should be adjusted at the same time as the company structures change to enable efficient consolidated supervision. This principle has been adopted in the Basle Core

¹⁸ In New Zealand's supervision regime, where the home country principle does not apply, foreign banks have to disclose the operation of their branches in New Zealand so that the host country can make the necessary comparisons and market assessments.

Principles and EU legislation (so-called BCCI-Directive and Directive on Consolidated Supervision).¹⁹

A severe problem related to blocking structures that would make efficient supervision impossible could be that the supervisory authorities only have available the extreme threat of withdrawing the banking licence of the institution in question, on the basis that the licensing requirements are no longer met.²⁰ Exercising this extreme threat is not likely to be practicable in most cases. As a minimum, supervisors could have the right to require (eg by issuing binding regulations) that, following changes in company structures, institutions must adjust their internal control systems in a way that ensures monitoring of exposures and capital adequacy at the consolidated level without significant breaks.

Incentive issues. Distinct role and responsibilities and adequate accountability are necessary to ensure that any organization has incentives to operate efficiently.²¹ Host supervisors' incentives to monitor foreign institutions and deliver their input to the supervisory process may be blunted by the fact that they do not have the ultimate responsibility of overseeing the safety and soundness of these institutions. The concern could be pronounced in the EU supervisory framework, in which the formal obligations of the host authorities are limited when the foreign-owned banks operate through branches or remote cross-border supply.

One way of increasing the host supervisors' incentives would be to specify explicitly the inputs the authorities in charge of the consolidated supervision expect from the host authorities. It would be preferable for these agreements to cover explicit aspects of conditions in the host markets. Another way would be to increase the weight of the systemic banking industry-level issues at international fora, where host supervisors could base their contribution on their expertise of local market conditions. Finally, if home supervisors actively inform the host authorities of significant matters affecting the established institutions' overall performance, they could feel more committed to the overall supervisory process.

Public disclosure of information could reduce the incentive problems. Both supervisors would be concerned to see speedy disclosure so they can complete their analyses.

Specific incentive issues may also arise because of different market sizes. Establishments of small (country) banks in large financial centres might not receive so much attention from the host authorities, if their significance in the overall market is small. However, their exposures could be very important for

¹⁹ The Core Principles state that 'banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision' (Principle 5). Moreover, the Minimum Standards require that 'all international banks should be supervised by a home country authority... that has right to prohibit company structures which impede supervision', and that 'the creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country establishment'.

²⁰ In the case of the Netherlands there is a principle of 'structural supervision' defined in the legislation concerning the supervision of credit institutions and insurance companies. According to this principle mergers and acquisitions of credit institutions or insurance companies, or acquisitions of ownership stakes between credit institutions and insurance companies, require a prior consent (declaration of no-objection) from the ministry of finance.

²¹ Goodhart (1996) discusses the general problems of assuring proper accountability and incentives for supervisors.

their overall soundness, and the home country supervisor would benefit from comparative information on them.

If banking business becomes significantly concentrated in large pan-European or global banks in the future, supervisory responsibilities would accordingly tend to concentrate in the home authorities of these institutions. The host supervisors (without their 'own' multinational institutions) would face not only incentive, but also heightened resource constraints, since their tasks would become significantly reduced. These authorities would also lose funding directly to the extent that it is based on charges levied on supervised institutions.

Co-ordination of supervisory activities. The issue of implementing efficient co-ordination involves two dimensions: bilateral/multilateral co-ordination of supervision at international fora; co-operation based on general guidelines/case-by-case agreements concerning individual institutions.

Clearly, the internationalization process increases the need for both bilateral and multilateral co-ordination. Co-ordination and co-operation among supervisors has already increased considerably. The actual involvement of foreign institutions in the particular countries and the technical and organizational aspects of ensuring adequate co-operation largely dictate the extent of bilateral co-ordination. Multilateral co-ordination has its role, *inter alia*, in providing guidance and direction for arranging the bilateral relations and facilitating exchange of information and establishing systemic trends in financial markets.

The supervision of large multinational institutions (or large conglomerates) seems to require case-by-case-agreed supervisory procedures. The duties of the various authorities involved could be unclear if they rest on general supervisory agreements alone. International consolidation (as well as conglomeration) increases the significance of this method of allocating tasks and responsibilities among supervisors (following the general principles stipulated elsewhere). The benefit of this is that agreements on supervisory co-ordination would then evolve in line with the actual changes in market structures.

5 Implementing and monitoring disclosure requirements

As we noted in the previous section, there are co-ordination difficulties for home and host country supervisors in obtaining the appropriate information that they require from banks under the principle of home country control. If much of the information they require is available rapidly through public disclosure then the problem is reduced to following up signs of difficulty and asking questions where the results are unclear.

The key question is whether shifting emphasis to disclosure could provide the necessary information in the EEA. Unfortunately the onus for implementation of disclosure rules lies not with the host countries that could have the severest informational problems, because of a lack of information through substantial foreign control of their banks, but with the home countries of those banks. However, implementation by a host country would encourage foreign banks to comply voluntarily if they did not want to face a competitive disadvantage. If domestically controlled banks are providing a wide range of information that permits depositors, creditors and other involved parties to assess their quality,

foreign controlled banks that remain silent on the subject will find it more difficult to demonstrate that they are in some real sense 'better'. In this case foreign controlled banks may decide to get themselves locally incorporated so that they can benefit from the same regime and perhaps save on compliance costs.²² They may also press their own authorities to adopt a similar regime, so that the bank as a whole is not at a competitive disadvantage.

The content of banks' disclosure requirements and their international harmonisation has been recently addressed at the main international fora (EU, IASC, Basel Committee on Banking Supervision, IOSCO). At present, countries' disclosure requirements show considerable differences. The focus of the discussions has been on increasing public information about risk taking strategies, risk exposures and risk management tools, where advances would seem to be mostly needed. Qualitative information has received a lot of emphasis and there has been a move toward valuing assets in terms of their likely realization values (implying mark-to-market when applicable).

Development along these lines would certainly increase the ability to assess the risks of individual institutions. Although the international accounting conventions relating to financial reporting now cover the presentation of the information required for disclosure in a manner that enables both comparability across banks and an adequate quality for a meaningful assessment, EU accounting requirements only permit this approach to reporting, they do not compel it. The valuation of assets on a mark-to-market basis is by no means universal outside the Anglo-Saxon countries and auditing conventions do not necessarily provide for the appropriate independent cross checks at present (Mayes, 1998). Quarterly accounting is becoming steadily more common in the United States and indeed financial companies produce substantial unaudited information monthly to assist monitoring and decision-making. The practice is less common, though increasing, in Europe. Without quarterly disclosure within a few weeks of the end of the quarter it is unlikely that the quality of the information will be sufficient for either supervisors or markets to form an adequate up-to-date view of the quality of the bank.

Many countries are currently in the process of implementing mechanisms for more effective dissemination of information. The example of New Zealand is worth viewing, as it offers the only example of a supervision regime that is extensively based on market discipline. Both increased disclosure requirements and penalties that increase the incentives for proper disclosure have been implemented there. Moreover, authorities and participants there already have some practical experience. Here, however, we discuss only the disclosure-related elements of that regime.

There are two key characteristics to the information disclosed in New Zealand (Mayes, 1997):

²² Shifting towards public disclosure would reduce compliance costs for the banks if the range of data required solely by the supervisor for its own purposes is reduced. Banks can be expected to choose to publish information in a form related to their own control and monitoring mechanisms. While supervisors may decide on the minimum levels for disclosure, pressure by the market will develop it where necessary (Mayes, 1998).

- 1 quantitative data including:
 - the income statement and balance sheet (including a 5 year summary of key financial data),
 - directors and their interests,
 - asset quality and provisioning,
 - the number of large exposures (including interbank exposures) as measured relative to the bank's equity,
 - related party exposures, as measured relative to the bank's tier one capital,
 - sectoral exposures,
 - capital adequacy, including off-balance-sheet items,
 - market risk exposures,
 - credit rating (if held),
- 2 information on risk management and other indicators of prudential behaviour.

Mayes (1997) shows an example of an actual disclosure statement. These typically run to some 40 to 60 pages and are used by the banks concerned as part of their publicity and assurance to counterparties and major customers. Although any member of the public may request a copy few do so. Neither do they pick up the two-page 'Key Information Summary' that is available in every branch. It is the market analysts, credit rating agencies, counterparties and, above all, competitor banks that pore over the documents and come up with assessments of the banks that are then publicised. Market discipline occurs not so much because of what these commentators say but because of what they might say. Banks are keen to act so as to avoid the need for unwelcome disclosures.

One of the key features of the disclosure statements is that they require reporting of peak exposures, not just period average or end-period values. Thus the extremes of the risk distribution are revealed. In such circumstances violations of the limits laid down will from time to time occur and Mayes (1997) documents one of them, when the National Bank of New Zealand greatly exceeded the permitted limit to connected party exposure. This occurred because of a failed transaction. It was reported to the supervisor immediately but because it was an isolated incident and there were no adverse consequences its disclosure at the end of the quarter went completely without remark in the markets.

The quantitative data revealed under these circumstances may be rather less than many supervisors require at present but the remaining requirements in practice may be more effective in encouraging prudential behaviour. Not only do bank structures have to be disclosed but risk management procedures and Value-at-Risk relating to the whole of the bank's activities including off-balance sheet items also have to be revealed. Each quarter all the directors of the bank including the non-executives (and having at least two non-executives and an independent chairman is also a requirement) have to sign the disclosure document attesting that all the necessary procedures for managing risk are in place and operating.

The New Zealand system relies on credible penalties. The directors are personally liable for false statements not just to the extent of a NZ\$25,000 fine or up to 3 years in gaol but also unlimited civil liability. Their careers and financial position are thus at risk. In such circumstances directors want to make very sure that a prudential approach and all the risk control measures are being properly

applied.²³ Those lower down the organisation in the bank will also be subject to signing off procedures and will also want to be convinced that all the necessary procedures have been followed and are likely to be followed in future.

Banks find it relatively difficult to describe prudential risk management systems, except where they are a named marketed product, and the New Zealand banks have opted to measure Value-at-Risk by a standard measure produced by the supervisor rather than through their internal methods. However, Bankers Trust New Zealand does go into rather more detail about its procedures as it considers these a selling point (Bankers Trust, 1997). There are possible solutions to this difficulty and Mayes (1998), for example, suggests that banks could precommit to manage Value-at-Risk within certain limits along the lines laid down by Kupiec and O'Brien (1997) for the United States. They can then be judged by their success and do not have to spell out the very technical methods that they use if they find that too difficult.

Increasing the role of disclosure, and meeting the preconditions for it to be efficient, could achieve two aims simultaneously as Stage Three of EMU develops. It could strengthen banking supervision in general by enhancing market discipline in a world of rapid innovation and growing cross-border activity, where the work undertaken by public supervisors becomes increasingly difficult. As we have argued here, it could also overcome some of the present and, especially, envisaged information and co-ordination disadvantages of the present supervisory framework, without the need to make formal changes in the framework (ie existing EU law). Supervisors could then be able to focus their attention more where their advantage lies, in handling the problems of systemic risk – to which we now move. However, rapid progress in this area is hard to achieve. As Mayes (1998) points out, negotiating the necessary changes in legislation can consume a lot of time, even if the main preconditions are already in place.

6 Handling of banking problems and crisis management

A host country supervisor with substantial foreign responsibility for banking supervision in its country faces potential difficulties from three sources:

- inadequate information
- conflicts of interest
- lack of power

The problem of information is relatively straightforward. The host supervisor will not be the primary recipient of information about problems in a foreign supervised bank unless the cause has emerged in its own jurisdiction. There is some danger that the efficient flow of information from home to host authorities may be impeded when the continuation of the business of a foreign institution operating in host territory is threatened. The home authority may be reluctant to reveal

²³ In fact, the New Zealand supervision regime is based on the idea that this threat acts as a real substitute for the close scrutiny of private information by a supervisor.

unfolding problems, because it might fear that widespread knowledge risks adverse market reactions that could actually take under the problem bank.

When disclosure requirements are efficient and cover emerging problems, host authorities' concern about the adequacy of information is reduced. Moreover, with disclosure of problems it is more difficult for a supervisor in the home country to exercise forbearance. It is then less likely for forbearance to be a source of conflict between home and host countries or for resolution to be delayed to the point that assets are fully depleted.

There is potential for a conflict of interest between the various authorities involved. In the event of a difficulty the home country supervisor will be focused on the consequences in the home country not on the host country, whose problem will be of secondary importance. The early stages of the BCCI saga demonstrate the need for appropriate crisis management mechanisms, since efforts to protect own depositors and creditors can hamper co-ordination between the supervisors from different countries (Liuksila, 1998).

Since the size of the EU countries varies substantially it would not be difficult to envisage circumstances where the systemic impact in the home (large) country is much smaller than the systemic impact in the host (small) country, even though the primary operation of the bank concerned was in the home country. Take a comparison of Finland and Germany for example. German GDP is about 20 times larger than Finnish GDP. Even if 80 percent of a German bank's operations were in Germany and 20 percent in Finland and the problem evenly spread, the consequences would be 5 times as important for Finland as they were for Germany. That order of magnitude of difference is quite sufficient for the home country to be willing to allow a failure while the host would prefer to see a resolution in order to limit the systemic consequences.²⁴

The first call if a bank is in difficulty will be on its owners. Failing that, the presumption is that the responsibility would be on the home country as lender of last resort (Schoenmaker, 1995). It is assumed here that this would be collateralized lending, as the bank is not actually insolvent. However, much of the problem occurs because drawing the line between illiquidity and insolvency is difficult and illiquidity is often a sign of deeper solvency problems. In any case making this distinction requires a lot of information. A country facing a greater systemic risk or deposit insurance risk may take a different view from the other administrations involved.²⁵ The position is complicated if the government is the owner or the part owner of the bank.²⁶

Clearly a host country will have some reluctance in lending to a foreign-based bank in difficulty because it would be unsure whether the loan would be to the benefit of those at risk in its own jurisdiction. If it is accurate in assessing the extent of the problem it might feel it was making advances that would turn out to be for the benefit of foreign shareholders and hence that it was doing the job of the home country. It cannot readily limit its support to its own jurisdiction.

²⁴ The determination of where an entity should be headquartered or registered is considered under the Basle Committee recommendations (see 'BCCI-Directive') in terms of absolute size not size relative to the market.

²⁵ Our discussion is phrased in terms of a single host country but of course in many cases there may be several hosts who are differentially affected.

²⁶ Although the government may exercise its roles as lender of last resort, supervisor and owner through different agencies (lender of last resort usually being through the central bank) these organisations can act together readily and quite swiftly in a crisis.

The host country will be concerned with systemic consequences under its own jurisdiction. However, its exposure in the event of difficulty by a foreign supervised bank is limited. The principle of home country control extends to the protection of depositors (under the Deposit Guarantee Directive).²⁷ If a branch of a foreign bank gets into difficulty it is the responsibility of the home country (deposit insurance system) to protect the depositors. The logic effectively is that it is the administration responsible for supervision and hence for trying to limit such occurrences that should also be liable in the event of difficulty. Foreign banks' subsidiaries are part of the host country deposit insurance scheme.

The problem under home country control bites most strongly when foreign establishment has taken the form of branches or cross-border supply. Foreign banks' subsidiaries have separate prudential buffers in the host state, and it may be possible for subsidiaries to continue to operate although the parent fails. This was the case in the Swedish Gota-bank failure in the early 1990s.

The host authority has limited powers to deal with the local branches of a foreign problem bank. There should not be significant worries that the 'good' assets of the failing bank would not be used equally in favour of the uninsured depositors and other creditors in different countries, when all creditors of the bank can prove their claims in the liquidation proceeding (so-called single-entity approach to liquidation).²⁸ This approach seems to be followed in many EEA countries. However, participation in liquidation and overseeing interests would be naturally harder for foreigners from different jurisdictions.²⁹ For subsidiaries, the situation is less complicated because there would be separate bankruptcy proceedings. This is not so clear-cut, however, since in some countries it is possible to commence a separate liquidation of a foreign branch, even though the single-entity approach is already being followed.

Obviously, efficient co-ordination and co-operation are difficult to achieve in situations when interests differ. The problem is then one of powers. In the New Zealand case, if such a difference in interest arose it would be possible for the Reserve Bank to appoint a statutory manager, with wider powers than a liquidator, who could not merely take over the running of the New Zealand branch of the bank in difficulty but also create a new locally incorporated entity to take over the assets. It would then be possible to recapitalise the New Zealand branch and continue trading, if that were the outcome thought appropriate for systemic stability and the protection of the New Zealand taxpayer. This is not generally possible in Europe (Liuksila, 1998). Powers of resolution of crises are not so great and the home country could choose a form of resolution that was more advantageous to its taxpayers and indeed creditors and insured depositors than was the case for the host country.

The problem is even greater when the difficulty falls short of insolvency. A statutory manager can be appointed in New Zealand while a bank is still solvent but undercapitalised. While such a manager clearly should not follow a course for shareholders that would be worse than they could expect under liquidation (or withdrawal of the banking licence for failure to meet the minimum prudential

²⁷ The directive sets out minimum compensation arrangements but some member states offer more than this minimum.

²⁸ The position is different for US, where foreign claims can be subordinated (Liuksila, 1998).

²⁹ Just because a bank is incorporated in one country it does not entail that its share ownership is equally concentrated, nor that the national distribution of its owners is similar to the national distribution of its activities.

standards laid down) as they could successfully sue, there are many options that might be more advantageous for the rest of the stakeholders in the bank, including the taxpayer. It would clearly challenge the principle of home country control if the host country could over-ride its wishes in these circumstances. The EEA therefore faces a clear problem.

Possible ways out. Time may be of the essence in a crisis. While there may be time for a few phone calls and rapid consultations major decisions have to be taken on the spot in the face of the evidence available if difficulty is not to be converted into failure simply by inaction. In these cases any resolution process that involves too complicated bureaucratic procedures will not work.

One potential solution to the co-ordination problem would be to assign powers to one competent body (in terms of having the ability to act) to act on behalf of all the interested parties and thus improve co-ordination in a crisis. The potential conflict of interests of home and host countries would support pushing the co-ordination responsibility 'upwards' to a European level body, which would need to lay down the procedures it will follow in advance so that it is predictable. However, the 'hands-on' information of individual banks' liquidity and solvency is at the national level. Thus, the requirement of adequate and timely information would not be easily met. Moreover, any possible use of public funds remains the responsibility of the Member States so a European level body could not drive the system.

It is not just that inter-administration conflicts need to be arbitrated and resolved on the spot but that the size of the problem, as banks increase their size and extend across borders, may become difficult for a home country to handle, when a significant proportion of the consequences and hence beneficiaries lie outside its borders. Since the introduction of the euro makes a single banking market in Europe a more real prospect multinational banks are likely to be encouraged. As it is, the largest European banks are already large compared to the GDP of the smallest member states. If they increase in size still further the problem is exacerbated.

7 Conclusion

We find that the potential internationalization of banking, which could take place as the introduction of the euro breaks down the barriers in European financial markets still further, could pose problems for the efficient working of the present European supervisory system. The difficulty is likely to be greatest for small countries who continue to have responsibility for systemic risk but have less and less ability to manage that risk. They are likely to become less well informed (both about individual banks and the market as a whole), less able to take pre-emptive action and have fewer means of resolving a crisis. Strengthening co-ordination between home and host supervisors so as to overcome these problems and supporting the host country's contribution to the overall supervisory process would be required. Home country supervisors will find their task more difficult to execute the more foreign operations they have to cover and will lack the more intimate knowledge of those markets possessed by the host supervisor.

Thoroughgoing co-operation among supervisors would ease the problem of information but this may not be adequate. A more substantial prospect for improvement would be offered if banks' disclosure requirements were expanded

and, especially, if credible penalties were installed to ensure prompt and correct disclosure. In this way not only will all supervisors gain access to information relating to their own and other markets promptly but the market itself will exert discipline over the multinational banks. Such a move towards a disclosure regime is warranted in any case, as it will tend to encourage prudential behaviour in a world of increasing complexity and speed of transactions. It would also tend to be of net benefit to all stakeholders in the banks, especially the taxpayer, given that the chance of a bailout is reduced.

However, disclosure is not a panacea. Host countries will still lack power to act early and to prevent spillover losses in the event of a crisis. While in this area co-operative arrangements among supervisors are least problematic in less urgent cases, the need to act promptly and decisively as well as the existence of potential conflicts of interest would seem to argue for a wider role for a European-level body that would help ensure efficient coordination in crisis resolution. The informational requirements of such co-ordination would naturally be quite substantial. If domestic banking systems become substantially foreign owned, the question of ensuring efficient crisis management becomes acute.

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