

## Conflicts between Home & Host Country Prudential Supervisors

by

Richard J. Herring<sup>1</sup>

Potential conflicts between home and host supervisors are legion and may impose heavy compliance costs on internationally active banks, create competitive distortions and jeopardize financial stability. Nonetheless, in comparison to efforts to achieve international cooperation in other economic spheres such as trade, exchange rates and macroeconomic policy, efforts to achieve international cooperation among bank supervisors are relatively recent. They sprang from the unanticipated consequences of applying traditional domestic closure practices to a bank that had substantial cross-border activities.<sup>2</sup> When the West German authorities closed Bankhaus Herstatt at 4:00 pm CET on June 26, 1974, they followed normal domestic procedures and waited until the end of the business day. But this was mid morning in New York, where the dollar leg of \$625 million of Herstatt's foreign exchange contracts remained to be settled. The closure of Herstatt thus resulted in abrogation of these foreign exchange contracts in New York and caused a prolonged disruption in foreign exchange trading and dislocations in the broader Eurodollar market as well.<sup>3</sup>

In reaction to the Herstatt crisis, the central bank governors of the Group of Ten formed what later became known as the Basel Committee on Banking Supervision ("Basel Committee")

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<sup>1</sup> Jacob Safra Professor International Banking and Co-Director of the Wharton Financial Institutions Center at the Wharton School, University of Pennsylvania. I am grateful to George Kaufman, Eric Rosengren and the other participants at the Chicago Fed conference on "Cross-Border Banking & National Regulation" for comments on an earlier version of this paper and to Tim Ng, Adrian Orr and Ian Woolford of the Reserve Bank of New Zealand for stimulating discussions on these topics.

<sup>2</sup> For simplicity, this brief review will focus on banks and mainly on the efforts of the Basel Committee, largely ignoring the parallel initiatives of the EU and other regional organizations. A consideration of the financial conglomerates would increase the complexity of the analysis by creating scope for more conflicts among specialized functional regulators within and across countries. For an overview of some of these issues, see Herring (2003).

<sup>3</sup> For additional information regarding the Herstatt crisis see Herring and Litan (1995) and the references cited there.

in the hope that better cooperation among banking supervisors could prevent such disruptions in the future. Although the Basel Committee was formed in 1975, almost thirty years passed before “Herstatt risk” in foreign exchange markets was virtually eliminated.<sup>4</sup> Other, broader conflicts in bank closure and resolution policies, however, have received relatively little attention in the public pronouncements of the Basel Committee.<sup>5</sup> This paper argues that these issues deserve a much higher place on the international supervisory agenda.

#### Home/host cooperation in historical perspective: the Concordat

The first official document of the Basel Committee (1975), known as the Concordat, set out guidelines for allocating supervisory responsibilities between home and host governments. The original Concordat delineated three main principles that have informed all subsequent cooperative efforts: (1) No foreign banking establishment should escape supervision; (2) Supervision is the joint responsibility of the host and parent authority, with the host assuming primary responsibility for supervision of liquidity and the parent assuming primary responsibility for the supervision of solvency; and (3) Transfers of information between host and parent authorities should be facilitated including both direct inspections by the home country authorities of foreign establishments and indirect inspections by the home country through the agency of host country authorities.

In several jurisdictions, significant legal barriers, often with criminal sanctions, impeded the sharing of banking information across borders and so new legislation was necessary to enable cross-border cooperation in banking supervision. Even though these at-the-border prohibitions

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<sup>4</sup> This required the extension of central clearing hours at central banks in the major centers and the launch of the Continuously Linked Settlement Bank.

<sup>5</sup> The chief exception is the report of the task force on dealing with weak banks (Basel Committee (2002)).

have been removed, the reluctance to share bad news about weak institutions remains a significant barrier to effective cooperation.

The Concordat was silent with regard to international lender of last resort responsibilities and deposit insurance. The central bank governors preferred to pursue a policy of “constructive ambiguity,” with regard to lender of last resort arrangements (if such arrangements actually were in place).<sup>6</sup> Moreover, during 1975, most of the members of the Basel Committee lacked formal deposit insurance although most have adopted some form of deposit insurance since then. Nonetheless, the interests of both the lender of last resort and the deposit insurer must be coordinated with those of the prudential supervisors and may cause conflicts if they are not. All three functions rely on timely and accurate information regarding the safety and soundness of banks.

The first real test of the Concordat occurred with the collapse of Banco Ambrosiano in 1982.<sup>7</sup> Unfortunately, the incident revealed a failure in the application of the first principle of the Concordat – that no internationally active bank should escape supervision. The Italian authorities (along with a consortium of Italian banks) bailed out creditors of the parent bank, but declined to bail out the creditors of the bank’s Luxembourg subsidiary, Banco Ambrosiano Holdings. This entity was regarded as a non-bank holding company by the authorities in Luxembourg and therefore not subject to banking supervision even though it raised more than half a billion dollars in the interbank market and owned two banks -- Banco Ambrosiano Overseas Ltd, the fourth largest bank in Nassau, and Banco Ambrosiano Andino in Lima, Peru. Moreover, Luxembourg corporate secrecy laws protected it from scrutiny by the Italian authorities. The Basel Committee responded to the incident with a revision to the Concordat

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<sup>6</sup> See Guttentag and Herring (1983) for a critique of the policy of constructive ambiguity.

<sup>7</sup> For additional details regarding the collapse of Banco Ambrosiano see Herring and Litan (1995) and the references cited there.

(Basel Committee, 1983) that recommended measures that should be taken to prevent another internationally active bank from evading effective official oversight.

This revision also strengthened the allocation of responsibilities between home and host countries by giving the home country authority explicit oversight of the entire consolidated balance sheet of the parent bank including foreign branches and controlled subsidiaries.<sup>8</sup>

Although this was intended to enhance the rigor and efficiency of official oversight, it was not sufficient to relieve the host authorities from concerns regarding the solvency of the local offices of foreign banks. If all creditors of all bank affiliates had an equal claim on consolidated assets of the banking group, the location of a banking group's capital would not matter. However, the reality of depositor preference laws and national bankruptcy procedures that often favor domestic creditors means that the location of capital does matter and the supervisory authorities cannot rely on surpluses in one location to offset losses in another.<sup>9</sup> Solvency must be monitored on both a stand-alone and a consolidated basis. Thus solvency supervision is likely to be duplicative to some extent and internationally active banks will find it very difficult to exploit the full gains from diversification that might be achieved by managing an integrated, worldwide network of banking offices without the constraint that each foreign office must satisfy stand-alone capital requirements. Differences among national bankruptcy regimes undermine the effectiveness of consolidated solvency supervision as a mechanism for enhancing the efficiency of international bank supervision.

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<sup>8</sup> The principle of consolidated supervision was intended to be part of the original Concordat, but the West Germans needed to enact new legislation in order to be able to implement the principle. It was officially announced in March 1979 (Basel Committee, 1979).

<sup>9</sup> This has particular force if the foreign affiliate is a subsidiary. The local supervisory authority must assume that under some extreme circumstances the parent bank may choose to exercise the option of limited liability and walk away from a troubled affiliate. Thus, in the absence of legally enforceable guarantees from the parent bank, host country authorities can take only limited comfort in the assurance that a deficiency in the net worth of the local office could be offset by a capital surplus in another office in another country.

The allocation of primary responsibility to the host country for oversight of liquidity is also less straightforward than it appears at first glance. Leaving aside the practical difficulties that sometimes arise in disentangling liquidity problems from solvency problems,<sup>10</sup> the allocation of supervisory responsibility to the host country seems most sensible when the foreign banking establishment is heavily engaged in local currency activity. But in many cases, foreign banking establishments deal largely in foreign currencies and the local currency competence of the host country is largely irrelevant.

The next crisis involving an internationally active bank was the collapse of Bank of Credit and Commerce International (BCCI) in 1991. It revealed that the Basel Committee had still not fully succeeded in implementing the first principle of the Concordat, even within the original member countries of the Basel Committee. Like Banco Ambrosiano Holdings almost a decade earlier, BCCI had taken root in the gaps in the international supervisory network. Not only did BCCI manage to evade consolidated supervision by the home country authority, it also managed to evade consolidated external oversight altogether for most of its existence by hiring different external auditors for each of its two main subsidiaries.<sup>11</sup> The Basel Committee responded to the BCCI affair with a restatement of the Concordat as a set of minimum standards for the supervision international banks (Basel Committee (1992)). The new revision also placed responsibility on the host authority to take action if not satisfied that a foreign bank is properly

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<sup>10</sup> There are, to be sure, a number of occasions, in which the distinction is clear cut. The liquidity problems faced by a number of banks in the aftermath of 9/11 provide an example. These banks were illiquid because their operational systems were down, but their solvency was never in doubt. If a bank's inability to borrow to meet liquidity needs stems from doubts about its solvency, the local authority may lack the appropriate information to make an evaluation. Moreover, as Altman (2006, 115) has argued, for members of the European Monetary Union "where currency considerations are no longer a concern, the shift of responsibility for liquidity from host to home supervisors is already long overdue."

<sup>11</sup> For a broader discussion of the rise and fall of BCCI and its implications for international supervision see Herring (1993 and 2005a).

supervised on a consolidated basis by a competent home country authority. These actions could include the imposition of restrictive measures or the prohibition of operations.

The BCCI case highlighted the challenge of making consolidated supervision a reality when neither the home nor host authority was willing to take the lead. The “supervisory college” that was improvised as a substitute proved entirely inadequate. But, most importantly it revealed fundamental differences across countries in processes and procedures for resolving an insolvent bank.

### Harmonization attempts: the Core Principles and Basel II

In addition to the Concordat, the Basel Committee has made substantial efforts to reduce conflicts between home and host country supervisors by harmonizing supervisory frameworks and regulations. Progress in this regard has been remarkable. When the Basel Committee was formed in 1975, not only did most supervisors not know their counterparts, even in neighboring countries, but also they approached their work with fundamentally different conceptual frameworks and remarkably different views on even the most basic concepts of supervision such as how to define capital and the appropriateness of onsite examination of banks. In a series of papers on supervisory concepts and best practices, the Basel Committee has made progress in reducing, if not eliminating many of these differences. The two most important notable achievements are (1) The Core Principles of Effective Banking Supervision (Basel Committee, 1997) and (2) The Accord(s) on Capital Adequacy (1987 & 2006).

The Basel Committee (1997, 2006) identified 25 core principles for effective banking supervision, organized under seven broad categories that included the preconditions for effective supervision, prudential regulations and requirements, methods of ongoing banking supervision,

information requirements and the formal powers of supervisors. These principles reflected a consensus among the members of the Basel Committee regarding good (if not best) practices in banking supervision and were intended to facilitate convergence in supervisory frameworks between home and host countries not only within the Basel Committee, but in all other countries as well.. Although the principles were not intended to be enforceable, the Financial Sector Assessment Program conducted by the IMF and the World Bank has used the Core Principles as a benchmark against which the supervisory frameworks of individual countries are evaluated. This has had the practical consequence of obliging countries to justify instances in which their approach to banking supervision diverges from the Core Principles and has probably accelerated international convergence in supervisory approaches.

The second harmonization initiative has been even more ambitious. It has moved beyond a mere convergence of supervisory concepts and frameworks to achieve convergence in rules for the minimum acceptable capital standards for internationally active banks. This required the Basel Committee to reach a consensus on how to measure regulatory capital and how various exposures should be risk weighted to form a risk-adjusted capital ratio that would be subject to a common minimum.<sup>12</sup> The first version of the Accord on capital adequacy (Basel I) (Basel Committee (1988)) defined two kinds of regulatory capital, set out fairly broad guidelines for assigning risk weights to exposures based on gross distinctions across borrowers or counterparties, and established minimum, risk-adjusted capital ratios that internationally active banks should meet. The Basel I approach offered relatively few options and thus little scope for conflict between home and host supervisory authorities.

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<sup>12</sup> Since no attempt was made to harmonize accounting standards or enforcement procedures, the consistency the application of rules was uneven.

Since 1997, however, the Basel Committee has been working on a new version of the Accord (Basel II) that is intended to be much more sensitive to market measures of risk and is also much more prescriptive than Basel I (Basel Committee, 2006b). Even so, it leaves open several hundred implementation choices over which home and host supervisors may differ. Under Pillar 1, banks may choose a standardized approach or either of two internal-ratings-based approaches for computing capital charges for credit risk. If unconstrained by the preferences of home or host country supervisory authorities, a bank could choose a different methodology for each of six kinds of credit risk exposure. The choices for computing capital charges for operational risk exposure include another three approaches with the possibility of making a different choice over eight different lines of business. Some supervisory authorities have chosen to constrain choice severely. Others have not. This can lead to conflicts between the home and host country with regard to the appropriate way to evaluate the capital adequacy of a foreign bank subsidiary. In the worst case, a bank that has foreign offices in several different countries may find that each country prefers a different methodology.

Pillar 2 of Basel II is intended to improve the harmonization of the monitoring and enforcement of rules, but requires much greater intensity of supervision than has been customary in many countries. Even though it should bring about a measure of convergence in supervisory approaches, it is also likely to lead to disagreements among supervisors regarding the validation of models, how to design stress tests and, indeed, the appropriate level of stress that a bank should be able to withstand. Moreover, the need for, and the size of negotiated additional capital requirements for concentrations of risk, liquidity risk and interest rate risk may be viewed quite differently by the parent and host supervisor. Preferences for Pillar 3 disclosures may also vary

with regard to supervisory emphasis on market discipline and transparency vs. direct supervisory intervention.

The Basel Committee is aware that this ambitious, new initiative requires closer cooperation between home and host country supervisors. In order to reduce potential sources of conflict, it has formed an Accord Implementation Group and guidelines for home-host information sharing for effective Basel II implementation (Basel Committee 2006). There has also been a proliferation of bi-lateral information sharing agreements and even attempts to form supervisory colleges for some of the largest, most complex internationally-active banks. These efforts may help reduce what might otherwise be enormous compliance costs.<sup>13</sup>

While these conflicts between home and host country supervisory authorities jeopardize the efficiency of the international banking system, they do not pose a serious threat to financial stability. Most of the efforts of the Basel Committee – from the Concordat to the Core Principles to the Accord – have focused on how to supervise internationally active banks that are in sound condition. While many of these initiatives have sought to ensure that banks remain in sound condition, surprisingly little has been done to harmonize supervisory practice and procedures with regard to troubled or insolvent banks. Yet these banks pose the most serious threats to financial stability and may cause some of the most intractable conflicts between home and host supervisory authorities.

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<sup>13</sup> The Basel Committee has set out essential elements of a Memorandum of Understanding to be used as a model for establishing bilateral relationships between banking supervisory authorities in different countries (Basel Committee (2001). See Herring (2005) for broad discussion of the potential implementation costs.

## Conflicts that may arise with regard to weak or insolvent banks

Experience has shown that in times of stress, information-sharing agreements are likely to fray. Bad news tends to be guarded as long as possible.<sup>14</sup> An example is the reluctance of the Japanese supervisory authorities to share with the US authorities the news of trading losses in Daiwa's New York branch. A trader in the New York Daiwa office had lost \$1.2 billion in a series of unauthorized trades over an eleven-year period from 1985 to 1996. When the trader finally confessed and the Japanese (home country) authorities were informed, a two-month lag occurred before the information was shared with the US (host country) authorities, the Concordat notwithstanding.

Bank managers are often reluctant to share bad news with their regulators because they fear they will lose discretion for dealing with the problem (and, indeed, may lose their jobs). Similarly, the primary supervisor is likely to be reluctant to share bad news with other supervisory authorities out of concern that the leakage of bad news could precipitate a liquidity crisis or that the other supervisory authority might take action – or threaten to take action – that would constrain the primary supervisor's discretion for dealing with the problem or cause it to take action rather than forbear.

Generally, the primary supervisor will use its discretion to forbear so long as there is a possibility that a bank's condition may be self-correcting, particularly if the alternative is closure.<sup>15</sup> A closure decision is sure to be challenged and so supervisors will tend to forbear until losses are so large that there can be no reasonable doubt that the institution is insolvent. Losses

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<sup>14</sup> As Baxter, Hansen and Sommer (2004, p. 79) note, "Once the bank's condition degrades, supervisors think less about monitoring and more about protecting their creditors. This creates a conflict among supervisors."

<sup>15</sup> Supervisors are more likely to be criticized for bank failures than for letting an insolvent institution continue operations and so this reinforces the tendency to forbear.

that spill across national borders, however, will intensify conflicts between home and host authorities and make it difficult to achieve a cooperative resolution of an insolvent bank.<sup>16</sup>

Currently, approaches to bank resolution differ substantially across countries. For example, countries differ with regard to the point at which a weak bank requires resolution. In many countries, intervention is required when a bank's net worth (which may be defined in a number of different ways) declines to zero, but in the United States, which has adopted a Structure Early Intervention and Resolution policy, action must be taken before net worth reaches zero, when the ratio of tangible equity to total assets is equal to or less than 2 percent. In Switzerland, the authorities may intervene even earlier if they perceive a threat to depositors' interests. Countries also differ with regard to what entity initiates the resolution process. The supervisory authorities? The courts? Or the bank itself? Clearly cross-border differences in regard to how and when the resolution process is initiated can cause delays that may be costly in a crisis.

In the event that a bank is declared insolvent, which jurisdiction will be the insolvency jurisdiction? The place where the bank was chartered? Where the management resides? The principal place of business? The domain of the largest concentration of assets? Or where the largest concentration of creditors resides? The collapse of BCCI revealed that each of these questions may have a different answer. Baxter, Hansen and Sommer (2004, p. 61) observe that it is difficult to devise a good jurisdictional rule that "would be both *ex ante* predictable (to defeat forum shopping or subsequent jurisdictional squabbling) and sensible in application (to discourage name-plate incorporations or prevent unseemly jurisdictional choices.)"

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<sup>16</sup> Freixas (2003) has argued that disagreements regarding the causes of losses and metrics for allocating losses across countries would lead to the underprovision of recapitalizations of international banks even when the social benefits of recapitalization exceed the cost. Goodhart and Schoenmaker (2006) share his pessimism about *ex post* burden sharing and consider two *ex ante* burden sharing mechanisms for the European Union.

The choice of jurisdiction, however, may have important implications for the outcome of the insolvency proceedings. Most countries have adopted a universal approach to insolvency in which one jurisdiction conducts the main insolvency proceedings and makes the distribution of assets, while other jurisdictions collect assets to be distributed in the main proceedings. But the United States follows a more territorial approach with regard to US branches of foreign banks. It will conduct its own insolvency proceedings based on local assets and liabilities. Assets are transferred to the home country only after (and if) all local claims are satisfied.<sup>17</sup>

The choice of jurisdiction will also determine a creditor's right to set-off claims on the insolvent bank against amounts that it owes the bank.<sup>18</sup> The BCCI case revealed striking differences across members of the Basel Committee (Basel Committee, 1992). In the United States, the right of set off can be exercised only with regard to claims denominated in the same currency on the same branch. Claims denominated in different currencies or on different branches may not be set off. In contrast, in the United Kingdom, the right to set off may be exercised even when the claims are not denominated in the same currency, on the same branch or even on branches in the same country. And in Luxembourg, the right to set off may not be exercised after a liquidation order and may be exercised before a liquidation order only when the claims "are fixed in amount, liquid and mature."

Similarly the ability to exercise close-out netting provisions under International Swap Dealer Association (ISDA) Master Contracts may vary from jurisdiction to jurisdiction. In principle, in the event of a default, the non-defaulting counterparty can close-out all existing transactions under the Master Agreement, which may include many different kinds of derivative

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<sup>17</sup> Baxter, Hansen and Sommer (2004, p.61) note that in the US, although the nationality of creditors is irrelevant, "only creditors of the local branch of the insolvent firm may participate...On the asset side, the insolvency official asserts jurisdiction over all local assets and assets outside the jurisdiction that are "booked" to the jurisdiction."

<sup>18</sup> The Basel Committee (1992, p.3) defines set off as "a nonjudicial process whereby mutual claims between parties such as a loan and a deposit, are extinguished."

contracts with many different affiliates of the defaulting bank, making them immediately due and payable. The non-defaulting counterparty can then offset the amount it owes the defaulting bank against the amount it is owed to arrive at a net amount. In effect, close-out netting permits the non-defaulting counterparty to jump the bankruptcy queue for all but the net value of its claims. But the ability to apply close-out netting and the extent to which it may be applied may depend on whether the country in which the insolvency proceeding is conducted has enacted legislation to ensure that all outstanding transactions under a master netting agreement can be terminated upon the occurrence of an insolvency and that close-out netting will be respected by the bankruptcy trustee.

The outcome of insolvency proceedings will also depend on the powers and obligations of the resolution authority, which may differ from country to country. For example, does the resolution authority have the authority to impose haircuts on the claims of creditors without a lengthy judicial proceeding? Does the resolution authority have the power (and access to the necessary resources) to provide a capital injection? Is the resolution authority constrained to choose the resolution method that is least costly to the deposit insurance fund as in the United States?<sup>19</sup> Or is the resolution authority obliged to give preference to domestic depositors as the law requires in Australia and the United States?

More fundamentally, what is the objective of the supervisory intervention and the resolution process? Is it to protect the domestic banking industry? Or to safeguard the domestic financial system? Or to protect domestic employment? Or to protect the deposit insurance fund? Or to minimize the fiscal costs of the insolvency to domestic taxpayers? Or to minimize the

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<sup>19</sup> The US resolution authority can choose a more costly resolution method only if the systemic risk exception is invoked which requires concurrence by two-thirds of the Federal Reserve Board, two-thirds of the FDIC Board, and the Secretary of the Treasury in consultation with the President that implementation of least-cost resolution would “have serious adverse effects on economic conditions or financial activity.”

spillover costs in all countries in which the insolvent bank conducts business? Only the last of these alternatives is implausible. The priority that supervisors will inevitably place on domestic objectives in the event of an insolvency is the main source of conflict between home and host authorities.

### Asymmetries between home and host supervisory authorities

Three asymmetries between the home and host country may create additional conflicts. First is asymmetry of resources. Although international agreements among sovereigns are, necessarily, based on the polite fiction that all sovereigns are equal, this is demonstrably not the case. Supervisory authorities may differ greatly in terms of human capital – the number and quality of employees -- and financial resources. This means that even if the fundamental conflicts of interest could be set aside, the home supervisory authority may not be able to rely on the host supervisory authority (or vice versa) simply because it may lack the capacity to conduct effective oversight.

Second, asymmetries of financial infrastructure may give rise to discrepancies in the quality of supervision across countries. Weaknesses in accounting standards and the quality of external audits may impede the efforts of supervisors just as informed, institutional creditors and an aggressive and responsible financial press may aid them. The legal infrastructure matters as well. Inefficient or corrupt judicial procedures may undermine even the highest quality supervisory efforts.

But, perhaps the most important conflict arises from asymmetries of exposures: what are the consequences if the bank should fail? Perspectives may differ with regard to whether a specific bank jeopardizes financial stability. The key issues are whether the bank is systemically

important in either or both countries and whether the foreign office is economically significant within the parent banking group. The various possibilities are arrayed in Table 1 where the columns indicate whether the foreign office is of significance to the solvency of the parent bank and whether the parent bank is considered to be of systemic importance in the home country. The rows indicate whether the parent bank is considered to be of systemic significance to the host country.

In general, if the host country entity is a branch, the host supervisory authority has a less active role to play and is much more dependent on decisions taken in the home country. But this vulnerability is offset to some extent by the greater likelihood that in the event of trouble, the branch is more likely to benefit from financial support from the parent or, if necessary from the parent country.

Table 1. **Alternative Patterns of Vulnerability**

		Home Country/Parent Bank			
		Systemic		Non-Systemic	
		Significant	Insignificant	Significant	Insignificant
Host Country Entity	Systemic	(a) High Priority Both	(b) High Priority Host Country	(c) High Priority Host Country	(d) High Priority Host Country
	Non-Systemic	(e) High Priority Home Country	(f) Low Priority Both	(g) Low Priority Both	(h) Low Priority Both

In cases (f), (g) and (h), conflicts of interest are not likely to be a problem. In all three cases the local office is not of systemic importance in the host country and so, apart from issues that might raise concerns about the reputation of the host country financial system, the host country supervisors will lack incentive to take an active role in supervision. In cases (f) and (h), the foreign office is assumed to account for an insignificant amount of the parent bank's profits and exposures and so the parent supervisory authority is likely to be content to exercise oversight with a very light touch. Similarly, with regard to (g), even though the foreign office does account for a significant share of the parent group's profits and exposures, the institution is not sufficiently large to be systemically important in either the home or host country. And thus both the home and host supervisors are likely to be willing to exercise relatively light oversight. Given the assumption the foreign entity does not pose a systemic risk in either the home or host country, these situations are not likely to pose serious problems.<sup>20</sup>

The most difficult situations are likely to arise when supervisory responsibility, potential fiscal responsibility and accountability to the electorate are misaligned. From the home country's perspective, the nightmare scenario is case (e) where the foreign office is not regarded as systemically important by the host country, but is a significant part of a systemically important bank in the home country. Whether the foreign entity is a branch or a subsidiary, the home country may feel that it needs to have primary supervisory oversight. The Concordat provides it

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<sup>20</sup> Two recent events involving rogue traders illustrate these cases. The first involves the losses in foreign exchange trading at the Baltimore office of the Allied Irish bank. This appears to have been an example of case (f). The office was not systemically important in the US and was not a significant part of the Allied Irish Bank group, even though the Allied Irish Bank group might be argued to be systemically important in Ireland. The losses were painful to shareholders, but did not pose a systemic threat in either Ireland or the United States. The collapse of Barings is an example of case (g). The Singapore office of Barings was not systemically important in Singapore and Barings, the Bank of England concluded, was not of systemic importance in the United Kingdom, but the Singapore office had accounted for a very significant part of the profits of the Baring Group in the years preceding the collapse. (See Herring (2005a) for additional details regarding the collapse of Barings.)

with this right and responsibility to do so in the case of a branch. The situation is a bit more ambiguous with respect to a subsidiary because both the home and host country can claim to be the primary supervisor. In view of the asymmetry of vulnerability, however, the host country may be happy to defer to the home country even if the entity is organized as a subsidiary. Case (a) may also pose a conflict because the entity is assumed to be systemically important in the host country and of economic significance to a systemically important bank in the home country. Both the home and host country will have an incentive to supervise the entity intensively. This may result in conflicts, but it is unlikely to result in gaps in supervisory attention.<sup>21</sup>

Cases (b) and (d) represent the nightmare scenarios for host supervisory authorities. The foreign entity is assumed to have a large enough share of local markets to be systemically important, while at the same time, being so small relative to the parent group that it is not regarded as significant to the condition of the parent banking group. In this case, the home country lacks incentive to exercise strong consolidated supervision that could be relied upon to ensure systemic stability in the host country. These kinds of situations are increasingly prevalent in central Europe, Latin America and Africa. The situation is only a little bit more tractable with regard to case (c) where the foreign office is systemically important to the host country and large enough to be economically significant to the parent banking group. Although the parent banking group is assumed not to be of systemic importance, the fact that the foreign office is a significant part of the banking group may elicit more attention from the home country supervisor.

How can these asymmetries be addressed in a way that will provide adequate assurances to both home and host country supervisors without imposing excessive compliance costs on internationally active banks? One possibility is an Uber-Supervisor Model, where sovereign

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<sup>21</sup> New Zealand provides a good example of case (a) because the big four subsidiaries of Australian banks that dominate the banking system in New Zealand are each economically significant to the parent banking group and each of the parents is arguably systemically important in Australia.

nations cede the necessary powers and resources to an international supervisory authority.

Although there has been some discussion of this model in the context of the European Monetary Union, where countries have already ceded one important aspect of sovereignty, control of the money supply, to the European Central Bank, such proposals have encountered seemingly insuperable concerns about how to share fiscal costs should a capital injection become necessary.<sup>22</sup>

A similar concern, applies to the Lead Supervisor Model, where the home country takes responsibility for supervision and host countries act as agents of the home country supervisor when necessary. Host countries, inevitably express misgivings about the misalignment of supervisory incentives with the political and economic costs of dealing with systemically important banking crises in the host country. Even a commitment by the home country to bear the fiscal costs of a capital injection should it become appropriate may not be sufficient to allay this concern, since the willingness to undertake a capital injection may depend on whether the losses are likely to fall most heavily on the home country if no action is taken. Moreover, some relatively small countries, such as the Netherlands and Switzerland, have such large, internationally-active banks, that they may not be able to make a credible commitment to absorb the fiscal costs of a recapitalization.

The Supervisory College Model has regained attention as a way of reducing the implementation costs of Basel II. However, the abject failure of a supervisory college to provide adequate oversight for BCCI raises a question about how accountability could be improved sufficiently to compensate for asymmetries in capabilities, resources and objectives across countries.

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<sup>22</sup> See Altman (2006) for a proposal that the 12 members of the European Monetary Union (EMU) adopt a common, EMU supervisory authority and form a common deposit insurance scheme that would better align supervisory responsibilities and financial burdens for members of the EMU.

Finally, the New Zealand supervisory authorities have introduced a Complete Autonomy Model.<sup>23</sup> More than 85 percent of the banking system is controlled by foreign-owned banks and the New Zealand authorities have been uncomfortable accepting the passive role assigned to the host country authorities with regard to resident foreign branches. They have insisted that systemically important foreign entities be organized as subsidiaries.<sup>24</sup> Moreover, they have buttressed this corporate separateness by additional measures that assure a subsidiary could continue operation without interruption (and without its previous owners) should it become necessary. This minimizes the extent to which the host supervisory authority must rely on the home country supervisory authority, but at some cost to banks that would prefer to manage their resources on a more integrated basis through a branch network.

### Concluding Comment

Conflicts between home and host supervisory authorities have contributed to and exacerbated cross-border banking crises.<sup>25</sup> Baxter, Hansen and Sommer (2006, p. 79) list 10 major banking problems that occurred from 1992 to 2002 in the overseas offices of internationally active banks. These problems included major losses and criminal wrongdoing, and were enabled by poor internal controls. Since the adequacy of internal controls is a major focal point of supervision, many of these events can be attributed, at least in part, to weaknesses in consolidated supervision and in host country supervision.

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<sup>23</sup> See Woolford and Orr (1995) for an exposition of the New Zealand model. See Kane (2006) for a discussion of the contrasts in regulatory cultures between Australia and New Zealand.

<sup>24</sup> This option is not available to host country supervisory authorities in the member states of the European Union. The single European passport concept gives banks chartered in any member state to open a branch in any other member state. See Mayes (2006) for a comparison between the system in New Zealand and the European Union.

<sup>25</sup> Baxter, Hansen and Sommer (2004, 67) list 19 international bank insolvencies that have been adjudicated at least in part in the United States.

The Basel Committee has made remarkable progress since 1975 in establishing protocols for international cooperation between home and host supervisory authorities and in harmonizing regulatory frameworks, concepts and even minimum capital standards. However, little has been accomplished with regard to how to deal with weak banks to ensure that they do not become a source of systemic instability.

Yet, supervisory cooperation is most likely to break down when weak banks become insolvent and create losses that must be allocated across national borders. Loss-sharing agreements are very difficult to negotiate either *ex ante* or *ex post* and conflicts over the allocation of losses may undermine efforts to manage a crisis and achieve an appropriate resolution. International cooperation may breakdown precisely when it is most needed. International efforts should focus instead on intervening in weak banks to achieve prompt corrective action before they become insolvent.

In this regard, Pillar 2 was a significant, missed opportunity. It came very close to adopting a Prompt Corrective Action (PCA) standard. Pillar 2 (Basel Committee, 2006a, p. 166) exhorts supervisory authorities to “undertake prompt remedial action if a bank fails to meet the capital standards set forth in this Framework.” Unfortunately, it did not reinforce this exhortation with policies and procedures that would remove concerns about usual tendency for supervisory authorities to exercise forbearance that can lead to large losses at resolution.

The next revision of the Concordat should correct this omission and emphasize meaningful prompt corrective action. This will certainly not eliminate conflicts among supervisors. Indeed, the reality of integrated international financial markets requires that supervisors execute such policies in a perfectly coordinated way and this will require changes in

the laws in many countries governing the resolution of banks. However, the potential gains are substantial. Prompt corrective action, strengthened by structured early intervention<sup>26</sup> and resolution measures, will buttress supervisory discipline with market discipline, thus adding force to Pillar 3. When the losses that must be allocated are confined to shareholders, conflicts among supervisors should greatly diminish.

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<sup>26</sup> See Kaufman (1995) for an analysis of the prompt corrective action, structured early intervention and resolution policy in the United States.

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