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Cross-border Banking in Europe: Implications for financial stability and macroeconomic policies

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Summary: The global crisis has provided compelling evidence of the need to understand the role of banks in international finance. This policy brief introduces a new CEPR report analysing key aspects of cross-border banking taking a European focus. The report argues that policy reforms in micro- and macro-prudential regulation and macroeconomic policies are urgently needed for Europe to improve its efficiency and reduce its risk.

While in the two decades leading to the recent global financial crisis there has been a general growth in cross-border banking activities around the world, there are several important aspects specific to Europe. One of them is the asymmetric nature of cross-border banking within the EU, with Western European countries being both home and host to large cross-border banks and Central and Eastern Europe being exclusively hosts to such banks. The recent crisis has caused a general retreat and consolidation in cross-border banking. However, compared to previous experiences, cross-border banking itself seemed to have played a relatively positive role during the crisis – in particular in the countries in Central and Eastern Europe that rely heavily on foreign banks. Rather, we argue in our new CEPR report that the crisis has been exacerbated by an inadequate response of regulators, stemming from a misalignment of regulatory incentives and a lack of an appropriate resolution framework on both national and supra-national level.

We examine the structure of cross-border banking flows in the EU and evaluate whether these flows tend to reap the potential benefits from cross-border banking or whether they create risk concentrations that may amplify financial vulnerabilities. We argue that it is key to evaluate this issue not only at the level of the individual countries, but also at the EU-level. This is because individual countries may be well diversified but the EU or the Eurozone overall may exhibit overexposures. Based on several new metrics we find that the structure of the large banking

centres in the EU tends to be well balanced. However, problems are identified for the Central and Eastern European countries which are highly dependent on a few West European banks, and the Nordic and Baltic region which is quite interwoven without much diversification. At the system-level, we find that the EU – in contrast to other regions – is poorly diversified and has an overexposure to the US.

We also examine the rationale for macro-prudential regulation. We argue that the increasing importance of cross-border banks – in terms of their sheer size but also because of systemic interdependencies and hence the systemic risks they pose – suggests that banking issues should be taken into account when dealing with macroeconomic problems. This requires a partial reversal from strict inflation targeting – the dominant paradigm for monetary policy prior to the crisis – as it does not take into account financial stability issues – even though financial stability is an important prerequisite for effective monetary policy. We also argue that cross-border banks are particularly prone to various important sources of systemic risk, which require macro-prudential regulation to address them. One such risk is that in times of crisis, the prices of assets may no longer reflect fundamental values. This is particularly problematic when institutions have to adhere to mark-to-market accounting.

Policy recommendations for sustainable cross-border banking

Based on the analysis in the report we derive some key policy recommendations. We argue that these recommendations should focus on solutions at the European – rather than the national – level. This is because the only real alternative to this is to require cross-border banks to organise themselves as a string of national stand-alone subsidiaries, which foregoes the significant benefits of having a single market in the EU.

Macro-prudential policies

1. Applying macro-prudential tools to prevent bubbles

Different forms of macro-prudential regulation may be used to prevent bubbles. An example is limits on loan-to-value ratios that would be lowered as property prices increase at a faster pace. Next, Basel III introduces a countercyclical capital charge that increases when the economy is in upswing (credit growth to GDP is above trend) and decreases in the downswing. These tools are applied at the country level, as asset price bubbles tend to be country specific.

2. Monitoring the national application of macro-prudential tools, exposure to cross-border banks and overall exposures of the EU banking system

As important as the application of macro-prudential tools on the national level is a proper monitoring at the EU level. Institutions, such as the European Systemic Risk Board (ESRB) and the ECB, are critical in this context. Similarly, a careful analysis of the exposure to cross-border banks for each EU member and of the diversification of this exposure is called for. Moreover, the aggregate exposures of the EU banking system should be monitored by the ESRB and ECB.

3. Risk-weights for sovereign debt

Banking regulation should recognise that the debt of countries, including OECD countries, can be risky. One way to do this is to assign risk weights and diversification requirements on sovereign debt. This could be done in the Basel Committee on Banking Supervision, consisting of central banks and supervisors.

4. Mark-to-market rules to avoid mispricing of assets

As long as markets are efficient, mark-to-market accounting dominates. However, if as during times of crisis they cease to be efficient, market prices do not provide a good guide for regulators and investors. When market prices and model-based prices diverge significantly (more than 2% say), financial institutions should publish both. If regulators see many financial institutions independently publishing different valuations they can deduce that financial markets may no longer be efficient and can act accordingly.

Macroeconomic policies

5. Eliminating tax deductibility of debt

Minimum capital is needed to foster sound banking, but equity is perceived to be more costly than debt. One of the reasons why capital is privately more costly is that in many countries debt interest is tax-deductible at the corporate level but dividends are not. The removal of tax deductibility across all sectors can go some way towards reducing the incentive to use debt rather than equity in financial institutions.

6. Bankruptcy regime for countries

A solution to the problem of sovereign default is a bankruptcy mechanism of some kind that would limit the need for a bail-out. This would remove a great deal of the uncertainty, especially if the process could be expedited, as well as reduce moral hazard risks. One way that such a mechanism could work is for the country to declare it cannot fully meet its debt obligations, which would be verified by a team from the IMF, ECB and the European Commission that would then assist in designing the optimal repayment plan. A high priority for this element of the proposed European Stability Mechanism (ESM) is to establish this bankruptcy mechanism in a transparent and predictable fashion.

7. Standing foreign exchange swap facilities

Currency mismatches are an important feature of cross-border banking. In crisis times, shortages of certain currencies can and do happen. When central banks arrange foreign exchange swap facilities, they can provide the private banking sector with sufficient foreign currency to alleviate any shortages. Adjustments to mandate and legal regime of the central banks involved might have to be made.

Resolution framework

8. Compatible bank resolution regimes including contingent capital

Reforms of bank resolution regimes at the national level is critical in order to avoid corner solutions, such as costly and moral hazard inducing bail-outs, or lengthy and disruptive liquidations. In the aftermath of the crises, many countries are therefore in the process of introducing special resolution regimes to allow for orderly and swift resolution. These national regimes should be compatible in order to facilitate the resolution of cross-border banks. Next, shareholders and unsecured-debt holders should share in the losses to a larger extent than they currently do. Banks could therefore issue convertible debt that could be converted into equity in the event of a crisis. These so-called CoCos have two main advantages. First, it is not necessary for banks to raise capital in difficult times as it would already be available. Second, contingent capital allows sharing losses with debtholders. This would also have a disciplinary role and would induce bank managers to behave more prudently.

9. European-level deposit insurance and bank resolution framework

The credibility of current deposit insurance arrangements based on the home country principle for cross-border banks is in question. A European deposit insurance fund would address this lack of credibility. It would also reinforce the notion that cross-border banks should be resolved at the European level. While different institutional solutions are possible, a European-level framework for deposit insurance and bank resolution is critical in order to enable swift and effective intervention into failing cross-border banks, reduce uncertainty and strengthen market discipline. Depending on the choice of resolution authority (supervisor or central bank), the new European Banking Authority or the ECB can be given this central power in the college of resolution authorities.

10. Resolution framework on bank group level with ex ante burden-sharing agreements

Resolution plans for cross-border banks should be developed to allow for an orderly winding down of (parts of) a large systemic financial institution. As large financial institutions have multiple legal entities, interconnected through intercompany loans, it is most cost effective to resolve a failing bank at the group level. This can imply a split-up of the group, sale of parts to other financial institutions and liquidation of other parts. In this context, ex ante burden-sharing arrangements should be agreed upon to overcome coordination failure between governments in

the moment of failure and ineffective ad hoc solutions. By agreeing ex ante on a burden-sharing key, authorities are faced only with the decision to intervene or not. In that way, authorities can reach the first-best solution. While burden-sharing should be applied at the global level, it can only be enforced with a proper legal basis. That can be provided at the EU level, or at the regional level. A first example, albeit legally non-binding, is the Nordic Baltic scheme.

Our policy recommendations are summarised in the matrix below.

Matrix of policy recommendations for cross-border banks

| | Macro-prudential | Monetary - Fiscal | Resolution framework |
|----------|---|--|--|
| National | 1. Applying macro-prudential tools to prevent bubbles | 5. Eliminating tax deductibility of debt | 8. Compatible bank resolution regimes, including contingent capital |
| EU | 2. Monitoring the national application of macro-prudential tools, exposure to cross-border banks and overall exposures of EU banking system | 6. Bankruptcy regime for countries | 9. European-level deposit insurance fund and resolution framework |
| Global | 3. Risk Weights for sovereign debt 4. Mark-to-market rules to avoid mispricing of assets | 7. Standing foreign exchange swap facilities | 10. Resolution framework on bank group level with <i>ex ante</i> burden-sharing agreements |

Reference

Allen, F., T. Beck, E. Carletti, P. Lane, D. Schoenmaker, and W. Wagner (2011), '[Cross-Border Banking in Europe: Implications for Financial Stability and Macroeconomic Policies](#)', CEPR Report, London.