Cross-Border Banking Supervision:

Three Papers on International Supervisory Cooperation and Ring-Fencing.

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Abstract

In the first paper, I analyze the incentive distortions between home and host supervisors and I propose policy options to address them. Incentives for international supervisory cooperation between home and host supervisors are analyzed using a simple example of a systemically important bank with centralized liquidity, capital and risk management functions. The policy options to address these incentive conflicts can be divided in three non-mutually exclusive strands; first, improved supervisory cooperation through supervisory colleges; second ring-fencing and third, a binding code of conduct among nations. International bodies such as the G20, the Financial Stability Board and the Basel Committee have responded to the crisis in a concerted effort and publicly promoted the first policy option of better supervisory cooperation, particularly through the use of supervisory colleges and the establishment of cross-border crisis management groups. But better cooperation alone cannot address all the incentive conflicts. What is needed is a rigorous analysis to ensure the right incentives for home and host supervisors are in place at every stage of the supervision and resolution process.

The second paper analyzes the second policy option of ring-fencing in more detail. A growing number of supervisors, home as well as hosts, have been resorting to ring-fencing or territorial approaches. Higher capital ratios, dividend restrictions, restrictions on liquidity flows and even forced subsidiarization are gaining popularity. Their objective is to protect the interests of the domestic stakeholders of a foreign bank and to limit the effects of cross-border contagion. Ring-fencing has
a negative connotation as it comes at a cost for banks and for the efficiency of the overall global financial system. But why do prudential supervisors ring-fence and what makes them more likely to ring-fence? And do all forms of ring-fencing really deserve this bad reputation? What are the risks these measures are addressing and which instruments have been used? Finally, what are the implications of ring-fencing for the banking group, financial stability in the home and host country, as well as global financial stability?

The third article attempts to shed light on the incidence and stringency of territorial approaches. A survey of 22 host supervisors with majority foreign ownership forms the basis for a vertical and horizontal analysis. First, a scoring system is developed to measure territorial bias on an individual country basis (vertical analysis). Second, the results are compared across two peer groups, EU and non-EU (horizontal analysis). I find that territorial bias is present to a varying degree in the prudential supervision and the regulations of the countries surveyed. On average higher territorial bias is observed in the non-EU group. Generally, there is also less dispersion in the EU, which can be explained by a common regulatory framework and the efforts to achieve supervisory convergence. Non-EU countries use a wider array of instruments; typically higher capital ratios, mandatory conversion from systemic branches to subsidiaries, stricter local governance requirements, and liquidity restrictions.