

Management of financial crises in cross-border banks

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Financial integration in Europe is increasing. The emergence of large, cross-border banks poses new challenges to the authorities. The management of financial crises in such banks will involve a number of authorities in many countries. Conflicts of interest between the authorities in different countries may hinder effective crisis solutions. Crisis management agreements between supervisory authorities and central banks aim to clarify the division of responsibilities and facilitate the exchange of relevant information. The Nordic central bank governors signed an agreement in 2003. This article provides an overview of developments and discusses the challenges facing the authorities.

1 Introduction

Banks are subject to specific supervision and regulation by the authorities because financial crises in the banking sector can have substantial repercussions on the real economy. Nonetheless, crises may occur. The responsibility for resolving a financial crisis in a bank lies primarily with the bank itself. Owners and management are responsible for ensuring that the bank does not end up in a critical financial situation and they also have the main responsibility for managing any crises that might arise. Experience of earlier banking crises shows, however, that the authorities must also have contingency arrangements in place for coping with crises.

The emergence of large, cross-border banks poses new challenges to the authorities. If a large cross-border bank should experience a serious financial crisis, central banks, supervisory authorities, deposit guarantee funds and political authorities in several countries will be involved. The current division of roles and responsibilities between the authorities has not, however, been adjusted to accommodate the extensive activity of cross-border banks in host countries, whether through a subsidiary or a branch.² Conflicts of interest may therefore arise between the authorities in different countries.

We begin this article by providing a short summary of developments in the banking sector in Europe. Section 3 focuses on the challenges facing the authorities with regard to managing financial crises in cross-border banks, including conflicts of interest. In Section 4, we discuss the work that has been done internationally to clarify the division of roles and responsibilities in relation to supervision and crisis management in cross-border banks. Finally, Section 5 describes some of the proposed solutions to the conflicts of interest that can arise in a crisis situation. A key question is the extent and content of the home country's responsibility for crisis management. For a cross-border bank organised in a branch structure, the responsibility lies with the relevant home country. For banks organised in a subsidiary struc-

ture, the formal responsibility lies with the host-country authorities. A number of factors suggest, however, that the responsibility for crisis management for banks in a subsidiary structure should also lie with the parent bank's home country authorities. Irrespective of the way responsibilities are assigned, the authorities should focus on avoiding crises, strengthening market discipline and ensuring that banks themselves take responsibility for resolving financial crises.

2. Developments towards cross-border banks in Europe³

Legislation for financial markets and financial institutions in the EU has been designed to promote a common market. The introduction of a common currency has expanded the basis for a common financial market in Europe. Integration has progressed furthest in the foreign exchange, capital and money markets, cf. ECB (2004), and has been more modest in banking, particularly in the retail segment, see EU (2004). There has been considerable consolidation in the banking sector, primarily by establishing large, national entities.

There is, however, a growing trend towards cross-border banking groups in Europe. A number of studies have shown that there are substantial efficiency gains in connection with the establishment of foreign banks; see Clarke, Cull, Peria and Sánchez (2001). In the EU, there is strong political pressure to lay the basis for more cross-border enterprises in general, including the financial sector. New rules for establishing European Companies (*Societas Europaea*) will facilitate cross-border mergers and the cross-border relocation of company headquarters in the EEA area. Large, cross-border banks have already been established in the Nordic, Baltic and Benelux countries.

In the regulation of cross-border banks, it is important to distinguish between subsidiary banks and branches. This distinction has important consequences with regard

¹ With thanks to Arild Lund and Charlotte Østergaard for their useful comments.

² Foreign banks can offer banking services to local customers either via a branch or subsidiary bank, or as cross-border services provided from abroad, for example via the Internet or via sales or representative offices. In this article, the term cross-border banks is used of banks that provide services to other countries via subsidiary banks or branches established in another country.

³ Structural developments in the European banking sector are discussed in Øverli (2003) (Norwegian only).

Nordea

Nordea is a Nordic bank with a subsidiary structure founded on the four previously independent Nordic banks Merita Bank, Nordbanken, Unibank and Christiania Bank og Kreditkasse, from Finland, Sweden, Denmark and Norway, respectively. The banking group has market shares of between 10 and 40 per cent in the four countries. The bank currently operates as a group of legally independent subsidiaries, but with business segments and risk control managed across the legal structure and across country borders. Nordea plans to convert the current subsidiary banks into branches and to establish itself as a European Company. The merged bank will have its headquarters in Sweden.

to the prevention and management of problems in cross-border banks. *Subsidiary* banks are separate, independent legal entities and are subject to supervision in the country where they operate – in the same way as other national banks. The parent bank is similarly subject to supervision in its home country, and the home country is also responsible for consolidated supervision of the group.⁴ *Branches* are not independent legal entities. Branch and parent company are one and the same legal entity. The responsibility of host-country supervisory authorities for the supervision of foreign branches is therefore limited. The responsibility for resolving a financial crisis in the bank will lie with the authorities in the parent bank's home country.

Even though the regulatory framework for banks in the EU provides for cross-border establishment using branches, the subsidiary structure continues to dominate. Dermine (2003) gives a number of reasons for this:

- The parent bank limits its exposure to the subsidiary bank.
- The subsidiary bank maintains a local connection.
- The bank maintains its membership in the national deposit guarantee scheme.
- There may be tax reasons for maintaining a subsidiary bank structure.

At the same time, centralisation in these cross-border banks is increasing. Thus, although subsidiary banks are formally maintained as independent companies, management of these banks is often centralised across global business segments, with global risk management and control (see the Basel Committee (1999)).

Table 1. Traditional view of host-country responsibility for foreign-owned branches and subsidiary banks

Host-country authorities are responsible for:	Subsidiary banks	Branches
Solvency assessment (supervisory authorities)	x	
Liquidity support (central bank)	x	x
Capital support (political authorities/Ministry of Finance)	x	
Deposit guarantee (deposit guarantee fund)	x	(x) ¹

¹ In the EEA area, branches of credit institutions based in another EEA state are entitled to purchase additional cover in the host country's deposit guarantee fund if the host country's guarantee fund has better coverage than the home-country fund of which the branch is a member.

3. Which authorities are responsible for cross-border banks?

The division of responsibilities between the authorities in different countries for subsidiary banks and branches of foreign banks has not really been adjusted to accommodate large cross-border banks.⁵ Table 1 provides an overview of the "traditional" perception of the division of responsibilities between the relevant authorities for a cross-border bank.⁶

The traditional view is that the host-country authorities are responsible for subsidiary banks, while responsibility for branches is divided between host-country and home-country authorities. It has been pointed out, however, that it would be natural for the home country's authorities to take broader responsibility for a global group with subsidiary banks or branches in a number of countries, including responsibility for those areas traditionally regarded as the host country's responsibility. Specifically, it could be argued that extraordinary liquidity support for a wholly foreign-owned subsidiary bank or branch should not be the responsibility of the host country's central bank. On the other hand, the host country's central bank will be responsible for financial stability in that country and it will therefore clearly have a keen interest in the crisis management of a large cross-border bank, especially if the bank is systemically important.

At present, no authorities are required to take into account the effects on other countries of a crisis in a large cross-border bank. The host country does not control crisis management in branches of foreign banks, while the home country normally focuses on problems in the domestic market without taking into account the adverse effects in the host countries of a bankruptcy. However, if the bank is organised in a subsidiary structure, the host countries will be in control of crisis management in subsidiary banks in the host country and

⁴ Home- country supervision is exercised by the authorities in the country where the bank has established its headquarters. Host- country supervision is exercised by the authorities in the country where the bank has established a branch. The latter term is often used to refer to host-country supervision of subsidiary banks. We will adhere to this convention in the following.

⁵ See for example Lastra (2003) and Herring (2004).

⁶ See Huizinga (2003) for a more detailed discussion. The table presents a simplified overview. In the EEA area, for example, the host country supervisory authorities currently have limited responsibility for liquidity supervision for foreign branches.

Table 2. Home-countries' and host-countries' views on support in the event of a financial crisis in a cross-border bank

	Bank is large in host country	Bank is small in host country
Parent bank is large in home country	1: Both interested in support	2: Differing views on support
Parent bank is small in home country	3: Differing views on support	4: No support

might seek to isolate the subsidiary banks from the rest of the group, so-called "ring-fencing". This may hinder a joint solution that might have been better overall.

Table 2 presents a simple, schematic overview of home countries' and host countries' views on support in the event of a financial crisis in a cross-border bank – depending on the size of the bank.

If the bank in question is a large bank both in the home and host countries (1), the authorities in both countries will be interested in minimising the adverse affects of a crisis. This may make it easier to find a joint crisis management solution.⁷ If on the other hand, the bank is small in the one country and large in the other (2 and 3), it may be more difficult to come to an agreement as to who should provide liquidity support or capital in a crisis. If the parent bank is very large relative to the home-country banking market and economy, the home-country authorities will be particularly interested in finding a coordinated solution – because they will not alone be able to raise the necessary funds to keep the bank in operation.

3.1 *Subsidiary banks*

As shown in Table 1, it is usually assumed that the host-country authorities have "home-country responsibility" for all banks established in the country, including subsidiary banks of foreign banks. A banking group with subsidiary banks in several countries therefore has to relate to many different authorities. This may result in overlapping areas of authority and give rise to potential conflict in a crisis management situation involving a cross-border bank. Crisis management in a bank with subsidiaries in other countries becomes even more complicated when these banks do not function as independent entities but operate under centralised management.

This can be resolved either by ensuring that subsidiary banks operate more independently, or by regarding and treating subsidiary banks more as branches, i.e. holding the parent bank responsible for a subsidiary bank's liquidity and solvency while giving the parent bank's home country authorities greater responsibility for supervision and crisis management.

In New Zealand, the authorities have instructed systemically important subsidiary banks to operate more independently, firming up on requirements that the board of directors of foreign-owned subsidiary banks

must be independent and expecting the bank to have technical and administrative systems that can function independently of the parent bank's systems in the event of a problem in the parent bank, see Reserve Bank of New Zealand (2004a and 2004b). One of the considerations behind the new regulation was the importance of ensuring that large, systemically important banks have assets in the country that can be made available in the event of a financial crisis in the bank, and that a board of directors with whom the authorities can communicate directly is in place in New Zealand. Capital requirements for the subsidiary banks also ensure that buffer capital is available in the country. This structure will allow the bank to be closed and reopened quickly – if serious problems should arise – thereby reducing the risk of financial instability in the host country as a result of a financial crisis in a cross-border bank.

Alternatively, the authorities may accept the trend towards more global, centralised structures in cross-border banking groups, while at the same time requiring the parent bank to take more responsibility for its subsidiary banks (beyond the limited liability that the equity capital represents). In other words, the parent bank must be expected to provide some financial support to subsidiary banks. US banking regulations include a similar, basic principle (of financial strength) requiring holding companies that own banks to provide financial and administrative assistance to their subsidiary banks, see FDIC (1987) and Ashcraft (2004).

Because of the limitations on shareholders' liability, the legal basis for claiming support from a foreign parent bank over and above the capital the bank holds in the subsidiary bank may be weak.⁸ Banking regulation has generally been focused on shielding banking companies in a financial group from this kind of claim from other companies in the group. However, if a banking group has been operating as though it were a branch structure, the court might instruct a parent bank to support its subsidiary bank.⁹ The court's decision will, however, remain unknown until a major financial crisis occurs in such a cross-border banking group. Whether a clearer answer can be found without such a crisis is an open question.

The parent bank must be expected to have a vested interest in supporting its subsidiary banks if they encounter problems, whether or not it is under a legal obligation to do so. If the subsidiary does not receive support, the resulting loss of reputation will quickly reduce the group's borrowing capacity in international capital markets. In addition, the parent bank has often provided substantial loans to subsidiary banks far in excess of the subsidiary's equity capital. In practice, then, the parent bank will usually support its foreign subsidiary banks in a crisis.¹⁰

With increased parent bank responsibility, it will be

⁷ If the parent company was established with a branch in the host country, the responsibility for support will mainly lie with the home-country authorities. If the parent bank has been established with a subsidiary bank in the host country, however, it is less clear where the main responsibility for support lies. Thus, even in a situation where both countries are interested in resolving the crisis together, there is potential for conflict.

⁸ For an interesting discussion of this issue, see Evans (2003), pp. 90-91.

⁹ See Goldberg (2003) and Hübkes (2003, p. 31) for discussions of these issues.

¹⁰ During the banking crisis in Argentina in 2000, however, the parent banks (Scotiabank and Credit Agricole) of some foreign-owned subsidiary banks did not intervene when the subsidiary banks went bankrupt.

natural for the authorities in the parent bank home country to assume greater responsibility for the banking group as a whole – including greater responsibility for the subsidiary banks. Strengthening home-country supervision in this way is included in the new Basel Capital Accord (Basel II). The supervisory authorities in the parent bank's home country will, for example, have a leading role in approving internal models for credit risk. The banking industry in Europe is in favour of an even stronger role for the home supervisor ("lead supervisor"), see European Financial Services Roundtable (2004).

The conversion of subsidiary banks that are not very independent into branches will result in closer alignment of the actual management structure with the bank's formal legal structure and also give a clearer lead role for the parent bank and the home-country authorities, both in general and in crisis situations. On the other hand, conversion to a branch structure will raise a number of new challenges for the host-country authorities, particularly if branches' activities in the host country are extensive.

3.2 Branches

One of the key issues is whether the home-country authorities, in a crisis situation, will take account of the effects of the crisis in other countries where the bank has branches.¹¹ The host-country authorities have generally little influence over crisis management in the bank and may therefore be interested in more influence and responsibility for crisis solutions affecting the branches, especially if the branch has extensive activities in the host country.¹²

In New Zealand, the authorities responded to the situation, instructing all systemically important branches in New Zealand with total assets in excess of NZD 10 billion to re-establish as subsidiaries (see the Reserve Bank of New Zealand (2004a)). A similar solution is not feasible in Europe, where the system is based on freedom of establishment and home-country supervision of banks. The question is then how to preserve financial stability in a branch structure, particularly when the branch is large in the host country.

Danmarks Nationalbank (2004) emphasises access to information about the banking group in order to alleviate the situation for the host-country authorities (p. 76):

"... it is crucial to the host countries that any formal framework for actual central-bank cooperation entails full and equal access to information on both the branch's and the bank's global financial position and risks. To this end, host-country and home-country

supervisory authorities have to engage in binding cooperation. The home country should not have an information advantage."

It is unlikely, however, that access to information will in itself remove the conflicts of interest that might exist between home-country and host-country authorities, cf. Table 2.

3.3 Deposit guarantee schemes

Ordinary deposits in banks are covered in most countries by bank deposit guarantee funds in the event the bank should encounter problems. In the EU, this is a home-country responsibility. If a large EU bank chooses to locate its head office in a small country, this responsibility may be a heavy burden for the home-country guarantee fund, and ultimately for the home-country's taxpayers if the state has to cover any guaranteed deposits that private deposit guarantee funds are not able to cover.¹³

Sweden's Deposit Guarantee Board (2003) has highlighted this problem and proposed *"that branch activity in other EEA Member States is guaranteed/protected by the host country guarantee system. The guarantee/protection should thereby continue to apply unchanged in each country, irrespective of the formation of a European Company."* The principle of home country responsibility, however, is an important element in EU regulation of banking activities. It is therefore not likely that the deposit guarantee responsibility will be transferred to host countries in the near future. Such a change would also imply that the relationship between supervision and guarantee fund responsibility would be broken, since the host country would not be responsible for supervision and monitoring of the bank.

If a subsidiary is converted into a branch, the current legislation requires that guarantee fund responsibility be transferred from the host country to the home country. This may have unintentional effects since the national guarantee funds have quite different structures. The EU Directive for deposit guarantee schemes is a minimum directive, and the guarantee schemes vary from country to country, both with regard to size and type of deposit covered. Deposits in Sweden have, for example, less cover than in the other Nordic countries.¹⁴ A branch can, however, purchase supplementary cover ("topping-up") in the host country guarantee fund. Supplementary cover is, however, seldom used today.¹⁵

The conversion of a subsidiary bank into a branch may also have a negative competitive influence on local banks. The transfer of the new branch to the home-coun-

¹¹ Freixas (2003) shows that there is no incentive for the home-country authority to contribute to an optimal crisis solution in situations where only host countries are affected

¹² See Mayes and Vesala (1998) for an early and very instructive discussion of these issues, particularly Chapter 6: Handling of banking problems and crisis management.

¹³ Strictly speaking, guaranteed deposits should never be too large for the deposit guarantee scheme if members' premiums are set at the correct level (actuarially correct).

¹⁴ The fund covers SEK 250 000 of sight deposits. The Deposit Guarantee Fund in Norway covers all deposits up to NOK 2 million.

¹⁵ No branches have purchased supplementary cover in Norway. A draft regulation concerning membership in the Norwegian Bank Guarantee Fund for foreign branches in Norway was circulated for comment by the Ministry of Finance in July 2004.

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- The authorities should ensure that large financial institutions can quickly provide relevant and updated information about their financial position in a crisis.
- Large financial institutions should carry out regular crisis management exercises and stress testing to test relevant risk factors.
- Responsibility for coordination vis-à-vis large financial institutions should be clearly defined, particularly in crisis situations.
- Agreements on crisis management should be established between supervisory authorities, including procedures for exchanging relevant information.
- Similar agreements should also be established where necessary between central banks and supervisory authorities.
- Competition authorities should also be involved in the work on crisis management as they may have to consider the competitive implications of crisis management measures.

try deposit guarantee fund will lead to a shortfall in the home-country fund, and other member banks will have to increase their payments for a period. In the host countries, however, the other banks will benefit if the converted bank is not permitted to withdraw payments already made to the fund.

4. International cooperation

The trend towards larger cross-border financial conglomerates has been extensively analysed and discussed in international bodies.¹⁶ As early as in 1996, the Basel Committee established a separate committee - *Joint Forum on Financial Conglomerates* – to monitor developments.¹⁷ In 1999, the Joint Forum published a report on the principles of supervision of financial conglomerates, see Basel Committee (1999). The G10 countries also established a working group to study the effects on monetary policy and financial stability of the ongoing consolidation in the financial sector. The group published an extensive report in 2001, see G10 (2001). In the EU, a group of experts has published two reports on crisis management (the Brouwer reports), see Economic and Financial Committee (2000 and 2001). These reports highlighted the need for clearer guidelines for crisis management in cross-border banks, and the importance of rapid and open communication between central banks and supervisory authorities when financial crises occur.

Several agreements (*Memoranda of Understanding*) have been drawn up between central banks and super-

Crisis management agreements (Memoranda of Understanding)

Nordic agreement

In June 2003, the Nordic central bank governors signed an agreement on the management of financial crises in a Nordic bank with activities in two or more Nordic countries. The agreement contains procedures for the coordination of crisis management between the central banks. The agreement emphasises nonetheless that the main responsibility for managing a crisis lies with the relevant bank or group. Central elements in the agreement are:

- In a potential financial crisis the central banks establish a crisis group responsible for providing joint and rapid access to and management of information. The agreement specifies the information that must be obtained.
- The crisis group contacts relevant authorities in the different countries, including the relevant supervisory authorities. If a bank's solvency is in doubt, the countries' Ministries of Finance should be consulted.
- If an MoU is established for a specific bank, one of the central banks is given the responsibility of keeping an updated fact-book containing relevant public information about this bank.

Agreements within the EU

The agreement between the Nordic central banks is based on an MoU that has already been established within the EU, see ECB (2003). The EU agreement involves both central banks and supervisory authorities and contains principles for the identification of the authorities responsible for crisis management, the required flows of information between all the involved parties and the practical aspects of supplying information. The ECB's *MoU on payment systems* (2001) lays the basis for cooperation and information sharing in general. The purpose of the agreement is to limit the systemic risk associated with central payments systems by ensuring efficient cooperation between those overseeing the systems and those supervising the institutions participating in the payment systems.

visory authorities to improve cooperation between the relevant authorities (see box). The Nordic central bank governors signed such an agreement in 2003. The Nordic supervisory authorities have drawn up a similar cooperation agreement.

Such MoUs can clarify some important aspects, for example information management and communication in a crisis situation. They are not, however, legally binding and are often fairly general.

¹⁶ A financial conglomerate is a corporate group where at least one of the entities is an insurance company and at least one is a bank or securities firm.

¹⁷ The Joint Forum was established in 1996 by the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The group comprises supervisory authorities from thirteen countries and an observer from the EU. The Basel Committee on Banking Supervision comprises participants from the largest industrialised countries (the Group of Ten).

In addition to the problems discussed in section 3, other factors may make it difficult to arrive at clearer guidelines and agreements for crisis management in cross-border banks:

- Financial crises differ.
- The authorities may pursue a policy of constructive ambiguity to avoid generating expectations of liquidity support.
- Different countries' authorities may also have different attitudes to the use of equity support for banks in crisis.
- Central banks also have varying views of which instruments are most appropriate in a crisis, for example general liquidity support to the market vs. liquidity support to (large) individual banks.
- Supervision of banks is exercised differently in different countries. There are different views on the scope and content of home country supervision.
- Rules for the winding-up of banks differ across different countries. Not all countries have separate rules for placing a bank under public administration.
- The flow of information between relevant authorities, particularly across borders, can sometimes be hindered by formal rules, weak cooperative relations or conflicts of interest.

Even though an MoU does not guarantee an unimpeded flow of information and effective crisis management, MoUs are nonetheless a considerable advance on improvising solutions in the midst of an ongoing crisis.

5. Further cooperation and proposals for solutions

The authorities in the Nordic countries are continuing to cooperate on supervision and crisis management in relation to cross-border banks. The Nordic central banks will work to expand their cooperation based on the signed MoU. In an international context, work in this field is continuing in various fora, including, for example, the ECB's *Task Force on Crisis Management*. Some proposed solutions are discussed in the following section.

5.1 National or supranational crisis resolution?

One possible way forward may be to transfer some of the responsibility for crisis resolution to supranational institutions. If so, these institutions must have access to relevant information so as to be able to assess the credit risk of a liquidity loan. So far, the idea of establishing a

supranational European supervisory authority or giving the ECB supervisory responsibility has met with strong resistance. And if the crisis is widespread and capital injection is required, the political authorities must in any case be involved. In the EU, the political authorities can discuss a crisis within the relevant EU institutions, but any financial support must still be granted by the national authorities.

Without formal supranational solutions, it is all the more important to ensure good cooperation between the central banks and supervisory authorities involved. Within the EU, new supervisory committees have recently been established to promote closer cooperation within the EEA area.¹⁸ In addition, the ECB is involved in the work to establish more effective crisis management procedures, for example within the BSC (Banking Supervision Committee of the ESCB).¹⁹ According to Goodhart (2004), the ECB should in general "...be encouraged ... to adopt a role of arbiter on handling financial crises when these have inter-country European overlaps, in those cases of disagreement and deadlock between the national bodies". Schoenmaker (2003, p. 57) also points out that efficient decision-making mechanisms in acute crises have been used previously within the EU, for example during the secret negotiations (between central banks, Ministries of Finance and the European Commission) that resulted in new parities within the EMS (European Monetary System). This shows, according to Schoenmaker, that it should also be possible to find appropriate decision-making mechanisms for crisis resolution in the banking sector within the EU.

If a financial crisis in a bank can be resolved without the extensive use of public funds, the problem of distributing support for the bank among the various national authorities may to a large extent be avoided. In this connection, Mayes (2004) highlights the importance of effective rules for placing banks under public administration so that large banks can actually be closed without causing significant damage. International coordination of such rules is therefore also an important measure in the management of financial crises in large, cross-border banks, cf. the World Bank's work in *Global Forum on Insolvency*.²⁰

5.2 Market discipline and private solutions

A natural way forward to minimise the use of public funds and the associated conflicts of interest between authorities dealing with a crisis is to strengthen market discipline and ensure that banks themselves take more responsibility for resolving financial crises in large

¹⁸ Under the Lamfalussy process, supervisory committees have been established for insurance, the securities market and banks; participants include representatives for central banks and supervisory authorities. Norges Bank, along with Kredittilsynet (Financial Supervisory Authority of Norway), is an observer in the CEBS (Committee of European Banking Supervisors), see <http://www.c-ebs.org/>.

¹⁹ The BSC also includes participants from supervisory authorities and central banks. It was recently decided that the BSC and the CEBS would cooperate closely in their future work on crisis resolution within the EU/EEA.

²⁰ See also Report of the Contact group on the legal and institutional underpinnings of the international financial system, G10 (2002).

UK banks establish a crisis fund

The UK central bank, the Bank of England, has asked the 14 largest banks, including HBOS, Barclays, Royal Bank of Scotland, Lloyds TSB, HSBC and Abbey National to establish a joint fund of GBP 2bn (about NOK 25bn) that can act as a safety net in the event of serious problems in the payment system. Each bank will contribute from GBP forty to four hundred million. The central bank emphasises that even though the probability of a serious crisis is very small, this fund is being established to avoid a situation where the central bank has to provide support for a systemically important bank in a crisis. Such a crisis would be very serious for the payment system as a whole and might at worst bring all customer payments to a standstill, thereby threatening London's position as a centre of finance, cf. Bank of England (2003, pp. 98–99) for further discussion.

banks. Gros (2003) remarks that the first step the authorities should discuss when a bank crisis arises is how to arrive at good private solutions.²¹

The authorities, for example, can create conditions and help to arrive at a solution whereby private participants purchase all or part of a crisis-hit bank. Or the authorities can instruct the banks themselves to establish their own crisis fund (see box). The guarantee fund in Norway, for example, can provide capital support to a crisis-stricken bank.

As part of the process to strengthen market discipline, it is important to eliminate the impression that some banks are so large and important that they will always receive support if they run into financial difficulties ("too big to fail"). Expectations of support may induce banks to take undesirably large risks and creditors may not monitor their loans – i.e. moral hazard problems. Kane (2000) maintains that banks consolidate in order to become so large that they "have to" receive support if they run into a serious financial crisis. Refusing an application to establish a large bank is not an option in the EEA area as this would conflict with the EU principles on the right of establishment. Expectations of automatic support may, however, be reduced if the authorities can send credible signals that a financial crisis in a large cross-border bank will be resolved without recourse to public funds. Particular emphasis should therefore be placed on formulating rules and frameworks that provide for effective crisis management without contributions from the public sector.

In Switzerland, efforts have been made to reduce the risk of having to use public funds in a crisis resolution by changing the regulatory framework so that it is not as easy for the state to provide support to companies in

Table 3 Selected large European banks ranked by capital adequacy. Per cent

Deutsche Bank	13.9
UBS	13.3
Fortis	12.4
Credit Suisse	11.8
ING Bank	11.3
Banco Santander	10.6
DnB NOR	9.8
HVB	9.7
Nordea Bank	9.3

Source: Bankscope

financial difficulties. In addition, Swiss supervisory authorities require the large international banks in the country to hold capital far in excess of the minimum capital requirements laid down in the Basel rules (see Table 3). According to the Swiss authorities, banks in Switzerland are not over-capitalised, even with a capital adequacy that is 20-50% above the Basel requirements (see Zuberbühler (2004)).

6. Summary

The establishment of Nordea has highlighted issues related to financial crisis management in cross-border banks for the Nordic authorities, in particular for banks with large, systemically important subsidiaries or branches in the host countries.

The responsibility for resolving a financial crisis in a bank lies of course primarily with the owners and management of the bank itself. Experience of earlier banking crises shows, however, that the authorities must also have contingency arrangements in place for coping with crises. To ensure effective crisis management, it is important that roles and responsibilities have been clearly defined in advance.

In a financial crisis in a cross-border bank established with a branch structure, the main responsibility for resolving the crisis lies with the authorities in the parent bank's home country. There are arguments to suggest that home-country authorities should also have the primary responsibility for banks in a subsidiary bank structure. This would reduce the number of authorities that banks have to relate to, and is in line with developments in banking where an increasing number of cross-border banks are organised in subsidiary structures under central management.

At the same time, it is important to take host countries' legitimate interests into account. This requires close cooperation between the authorities, for example through agreements (MoUs). However, these agreements cannot be expected to resolve the fundamental conflicts of interest that may arise in a crisis, and the issue of distributing liquidity or solvency support must therefore be resolved in some other way.

²¹ Under the Lamfalussy process, supervisory committees have been established for insurance, the securities market and banks; participants include representatives for central banks and supervisory authorities. Norges Bank, along with Kredittilsynet (Financial Supervisory Authority of Norway), is an observer in the CEBS (Committee of European Banking Supervisors), see <http://www.c-eps.org/>.

First and foremost, efforts should be made to avoid crises by establishing good early warning systems and appropriate regulatory frameworks for financial institutions. One relevant measure might be to set the required level of capital adequacy for large cross-border banks well above the minimum requirement.

Within the EU/EEA area, the consultation process can be strengthened within existing bodies, particularly in the new supervisory structure for the banking sector, where participants also include the central banks. The ECB will in any case have an active role in the event of a crisis in a large cross-border bank. More centralised structures for banking supervision and crisis resolution may emerge within the EU in the longer term.

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