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ROTTERDAM SCHOOL OF MANAGEMENT, ERASMUS UNIVERSITY

- ▶ Making diversity policies work

By Meir Shemla

- ▶ How to regulate international banks

By Wolf Wagner

- ▶ Can neuroforecasting predict market behaviour?

By Alexander Genevsky

- ▶ CEO extraversion and M&A behaviour

Chris Murray talks with Taco Reus

- ▶ Streamlining deliveries through crowdsourcing

By Alp Arslan

- ▶ Do apologies and favours make for happy consumers?

By Laura Straeter



How to regulate international banks

By **Wolf Wagner**

The practice of banking supervision has been thrust very firmly into the spotlight since the great global financial crisis began to unfold over a decade ago. In that time it has been the subject of endless debate and much disagreement.

The failure of internationally active financial institutions, such as Lehman Brothers, and cross-border banks, such as Fortis, Dexia or the Icelandic banks, played a prominent role during the global crisis. The collapse and rescue of UK banks Royal Bank of Scotland (RBS) and Lloyds/HBOS followed shortly thereafter, leaving both banks effectively nationalised. While Lloyds is now completely privately owned, RBS remains around 72 per cent UK state-owned.

currency unions such as the Eurozone even setting up a banking union. EU authorities are pushing for the banking union to be complete by October 2018.

A paper that I co-wrote with Thorsten Beck of the Cass Business School at City University in London, sets out to analyse the main trade-offs in modern banking supervision. My aim in this article is to describe certain elements of our joint research and articulate our conclusions to a broader audience.

appropriate and effective banking supervision solutions.

A potential disinclination for institutions in one country to co-operate wholeheartedly with their counterparts in another country further muddies the waters. A simple rule of thumb is that the more cultural similarities there are between different countries the greater will be their mutual awareness and so their tendency to co-operate. By contrast, countries that are culturally dissimilar will tend to demonstrate a noticeably lower degree of interest in significant co-operation. Banks in northern Europe will have a natural affinity with their peer group, but less so with, for example, banks from Africa.

If all countries were identical, it would be easy to agree on the right structure for international regulation and implementation would be straightforward. However, countries differ in practice along various dimensions, which increases the cost of closer co-operation and convergence. Countries differ in their legal systems, which makes it hard to specify a common set of rules and standards, forcing cumbersome adaptation of general principles to local circumstances.

Heterogeneity can arise from a different reliance of economies on banks and from differences in market structures. This influences the cost of bank failures but also the ease with which banks can be resolved. Heterogeneity can arise from differences in preferences. Countries may differ, for example, in how they view the role of the government in the economy (one consequence being differences in state own- ▶

“...the regularity and growing size of bank collapses down the centuries suggests that failures – human or institutional – still happen.”

As a result of the events that combined to create the global financial crisis, there grew recognition that memorandums of understanding and supervisory colleges are not sufficient to deal with large and systemically important cross-border financial institutions. Something more had to be done. Closer co-operation between supervisors, especially in the resolution phases, is one of the solutions identified, with

The precise and proper level for bank supervision remains in question. The debate is very much coloured by the inherent complexity of the subject, whether at the domestic or the more challenging cross-border level. Adding further shades and nuances to the underlying complexity are the political constraints almost inevitably imposed upon those charged with identifying, formulating and implementing

How to regulate international banks *(continued)*

By **Wolf Wagner**

ership), focus on fiscal independence or with respect to their risk tolerance.

A question occasionally, and very justifiably asked, is: why is banking supervision needed? Surely the industry attracts staff with an inclination to deliver service to customers and to do so efficiently. However, the regularity and growing size of bank collapses down the centuries suggests that failures – human or institutional – still happen. Supervision is made necessary by a combination of factors. These include, but are not necessarily limited, to the following:

- A lack of competence by staff in attempting to carry out the duties for which they have been trained. Failures at the individual level may result in large costs for society.

▶ OPINION

'If we want banks to operate under the same rules and under the same supervision across our continent, then we should encourage all Member States to join the Banking Union. We need to reduce the remaining risks in the banking systems of some of our Member States.

Banking Union can only function if risk-reduction and risk-sharing go hand in hand.'

Jean-Claude Juncker, President of the European Commission, State of the Union Address (13 September 2017).

- Sheer size: as in the case of RBS, which grew from being a modest regional bank into the world's fifth-largest bank. The bank famously had to be rescued by the UK government following its ill-timed purchase of ABN AMRO of the Netherlands.

- The unique nature of the banking industry is a further factor. Businesses in any industry can and do go bust. Governments can usually allow such businesses to fail, with equanimity, because the adverse fall-out will largely be restricted to the company itself, its shareholders, its creditors and its customers.

Even when supranational regulation is desirable from a cross-country perspective, individual countries' incentives of moving from domestic to supranational supervision can vary significantly. This explains why the move to supranational regulation often falls prey to political obstacles. For instance, countries may be of a different size, which may result in a supranational supervisor adopting to a greater extent the preferences of the larger country. This may reduce – or even eliminate – the incentives for smaller countries to join.

Similarly, a country with an international financial centre might object to supranational supervision as this is likely to result in an outcome that forces the country to internalise a larger part of the externalities posed by its banking system.

The collapse of a major bank will however almost always cause systemic and social costs. Customers can face

the loss of their money as a result of a bank's determination to maximise profits. There are few governments brave enough to allow this to happen to retail depositors, however much faith they might possess in capitalism. Hence the close supervision by conduct authorities, central banks and supranational institutions aimed at reducing the chances of a systemic event.

Towards conclusion

Our main hypothesis is that a one-size-fits-all approach is neither desirable nor realistic, as benefits and costs from moving towards supranational solutions differ greatly across different regions. Instead, we propose that the extent to which the regulatory architecture becomes supranational should be determined at the regional level, and sometimes even be country- or institution-specific. In particular, it should be set according to two factors: the strength of cross-border externalities from financial instability, and the extent of heterogeneity across the countries in question.

The global financial crisis demonstrated beyond a shadow of doubt that many commercial banks needed to be better regulated, better supervised and better capitalised. They also needed to take on less risk. These considerations have not yet been fully addressed. At least Italy's banks, still burdened with non-performing loans, are at last facing up to reality and selling distressed assets where they can find a willing buyer.

But there is no room for complacency. All other issues aside, regulators

and supervisors, like army generals, have a long history of being backward looking rather than forward looking. They have a reputation for tackling the battles of history rather than the battles of the future.

Banks will almost inevitably push back against the constraints being placed upon them, perhaps arguing that 'this time it's different' (arguably the four most alarming words in the financial industry).

Banks also display ingenuity in finding ways round regulations. That, combined with a willingness to put history behind them, represents a danger. As more than one experienced

market commentator has observed in the past, there is only one institution more dangerous than a bank with too little capital, and that is a bank with too much capital. ■

This article draws its inspiration from the paper *Supranational Supervision: How Much and for Whom?*, written by Thorsten Beck and Wolf Wagner. Accepted for publication in the *International Journal of Central Banking*.

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► OPINION

'A complete Banking Union is essential for the future of the Economic and Monetary Union and for a financial system that supports jobs and growth. We want a banking sector that absorbs crises and shares risks via private channels, thus ensuring that taxpayers are not first in line to pay. Today we are presenting pragmatic ideas to move forward with risk sharing and risk reduction in parallel. We hope that these will be a useful food for thought for EU co-legislators to reach consensus on the remaining measures by 2018.'

Valdis Dombrovskis, Vice-President for Financial Stability, Financial Services and Capital Markets Union (11 October 2017).

"The global financial crisis *demonstrated beyond a shadow of doubt* that many commercial banks needed to be better regulated..."

