

Greater international links in banking — challenges for banking regulation

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Banking regulators in many parts of the world are confronting the issue of how to marry their domestic policy responsibilities with the increasingly international activities of large banks. This paper highlights the issues arising, the solutions being adopted and the benefits and roadblocks that can emerge when integrating banking regulation. This is an area of considerable interest in Australia and New Zealand because of the common ownership of the largest banks in both countries.

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Introduction

A major issue being faced by banking regulators in many parts of the world is how to marry their domestic policy responsibilities with the increasingly international activities of large banks.

In common with most industries, retail banking began as a primarily domestic activity. Banking regulation for the most part also grew with a domestic focus — principally protecting domestic depositors and maintaining domestic financial stability. Often this regulation contained strict rules governing — and in many cases essentially banning — foreign entry to banking systems.

However, over time, there has emerged increasing international integration in the banking industry. In some cases this has been aided by governments recognising the benefits of competition in banking and liberalising entry into their domestic markets. And, most recently, banks 'offshoring' functions has created further internationalisation within banks — even in those that only offer services in a single country.

While this has been occurring, most countries have retained a strong domestic focus in their prudential regulation. As a result, some pressures have arisen in the domestic regulation of banks and in how best to maintain domestic financial stability as risks from banks based in, or with operations in, other countries increase. The challenge is, how can we benefit from the efficiencies in the banking sector that arise from international trade in financial services and capital flows while still maintaining the appropriate level of safety in the domestic banking system? Another way of putting this is that it is not simply sufficient to open your borders; you must also examine how your domestic regulatory frameworks interact with those of other countries.

Over the last few years, this issue has generated considerable interest and work in Australia — both in government and in the major banks — because of the common ownership of the largest banks in Australia and New Zealand. But Australia and New Zealand are not alone in having to confront these issues, with the European Union (EU) in particular attempting to integrate the regulation of its member countries.

This paper highlights the issues that countries, especially Australia and New Zealand, are considering and the benefits that can arise when integrating their banking regulation. Hopefully these issues stimulate debate about how regulation and banking might evolve across borders to generate economic benefits for countries while protecting them from financial sector vulnerabilities.

A short history of modern Australian banking regulation

Modern banking regulation in Australia essentially began with the introduction of banking legislation in 1945 that introduced strict quantitative and qualitative controls, interest rate controls and lending directives. 'In addition the system was not open to foreign bank entry and offshore transactions.'²

Over the intervening decades Australian banking regulation has moved away from such quantitative rules towards a system of risk-based regulation. This has recognised that overly constrictive regulation inhibits competition, innovation and efficiency — and that allowing financial institutions more freedom, while still managing risks, benefits the whole economy. In the process, regulation to address financial stability has become increasingly concerned with cross-border issues.

Liberalisation started with some tentative reform in the 1970s, with more substantial reform following the Campbell Inquiry in 1979. Reform was aimed at improving efficiency and stability in the tightly controlled banking sector, which in the 1960s and 1970s had lost market share to less regulated non-bank financial intermediaries. By the mid-1980s interest rate controls and credit directives had been removed and the licensing of foreign banks had been introduced. Foreign banks were initially only allowed to operate as local subsidiaries of their foreign parents. Foreign branch operations were allowed following a further relaxation of the regulations in 1992.

While Australia has substantially opened up its banking sector to foreign entrants, we maintain different regulation of foreign bank subsidiaries and branches in our market because of the 'depositor preference' rules in the *Banking Act 1959*. Depositor preference requires Australian incorporated banks, including local subsidiaries of foreign banks, to hold sufficient assets in Australia to meet deposit liabilities in Australia in the event of failure. It is difficult to apply depositor preference to foreign bank branches, as they are not separable from their parent, so they face restrictions on retail deposit taking to protect Australian depositors.

Financial deregulation in the 1970s and 1980s facilitated significant change in Australia's financial system over the next decade, with a large increase in banking assets and the development of new products, some of which were complex and risky. The trend towards product proliferation and the blurring of traditional institutional boundaries created new risks and challenges for regulators and again gave impetus for further reform of the regulatory system.

The *1997 Financial System Inquiry Final Report* — or Wallis Report — was largely a response to these market trends. Following the release of this report, our current

2 Edey and Gray (1996).

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risk-based functional approach to financial sector regulation was adopted. A functional approach to regulation attempts to achieve greater stability while ensuring competitive neutrality between different types of institutions, including the local operations of foreign institutions, offering products and services with similar characteristics.

There continues to be increased operation of banks across borders, exemplified by the operations of Australian banks in New Zealand. The challenge again posed is ensuring that any regulatory reform allows improvements in the efficiency and competitiveness of the marketplace without exposing the banking sector and economy to excessive risks.

Regulatory responses around the globe

The increased development of cross-border banking brings new dimensions to the issues facing governments and regulators in regulating banks. The questions expand from simply how to get the best outcome for your country to include: will foreign regulators' actions affect us; could we meet our domestic responsibilities and get the best outcome for two or more countries by choosing a different course of action; and how much reliance can be placed on systems and infrastructure located in other jurisdictions?

There have been a variety of responses.

Basel Committee on Banking Supervision

An early response was the setting-up in 1974 of the Basel Committee on Banking Supervision by the G-10 countries' central banks following serious disturbances in international currency and banking markets. Initially it discussed international cooperation to close gaps in the supervisory net. Gradually it has moved on to improving international supervisory standards by issuing core principles for banking supervision and developing a consistent capital adequacy framework.

The core principles address supervision of international banks with the aim that the local and foreign operations of international banks are sufficiently supervised by the home-country and host-country regulators in a consolidated fashion, while ensuring the compliance costs that could result from being supervised by multiple regulators are minimised.

The Basel Capital Accord aims to create convergence in international capital adequacy requirements. The Committee considered that this would strengthen the stability of the international banking system and remove competitive inequality arising from differences in national capital requirements.

Memorandums of understanding between regulators

Another response, which has been developed by regulators dealing with cross-border issues, is the use of practical expressions of intent in the form of memorandums of understanding (MOUs) with other regulators. These MOUs generally set out the responsibilities of different supervisors and contain protocols for effective information sharing and, more recently, cover responsibilities in a crisis situation.

Home regulators with banks which engage in cross-border activities often sign MOUs with host regulators in countries where the banks have significant operations. An example from Europe is the Austrian Financial Market Authority, which has signed a number of MOUs to ensure that it can supervise internationally operating Austrian banks on a consolidated basis.

In 2003, the central banks of Denmark, Finland, Iceland, Norway and Sweden entered a MOU on financial crisis management. It applies to any bank domiciled in a Nordic country that has cross-border establishments in other Nordic countries. In 2004, an additional, more specific MOU was signed on cross-border cooperation in the supervision of Nordea Banking Group, which is domiciled in Sweden and ranks between the first- and third-largest bank in each of the Nordic countries. The key motivation is that a decision by one central bank in a crisis situation will have important implications for other Nordic central banks.

All EU banking supervisors are also party to two EU-wide MOUs, signed in 2003 and 2005, which set out guiding principles for cooperation in crisis situations.

In Australia, in the last few years the Australian Prudential Regulation Authority (APRA) has entered into MOUs with the prudential regulators of New Zealand, the UK, Hong Kong, China, Germany, the USA and the Netherlands to assist with current or potential cross-border banking issues.

Legislative frameworks

The use of MOUs is a welcome development but regulators themselves can only do so much unless there are regulatory frameworks that facilitate cross-border coordination. This is usually the province of governments.

The EU is at the forefront of this issue as it is trying to integrate its member nations. The single banking market has been in place since 1993. The approach adopted involves three pillars:

- harmonisation of particular regulatory laws and practices;

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- home-country control of banks, reinforced through cooperation between national regulators — which means that a bank operating as a branch in other member states will be supervised by the regulator in the country of origin; and
- mutual recognition by national supervisors of the rules and regulations in the countries of origin of foreign bank branches operating in their territory.

The single banking market makes possible the granting of a single licence recognised throughout the EU. This allows credit institutions to set up branches and offer services throughout the EU and to compete on an equal footing.

The EU Financial Services Action Plan was set up in 1999 to provide a framework for progress to a single economic market in financial services. But continuing differences in approaches in different nations have led to concerns that there is still significant work to be done to reduce the regulatory burden faced by banks operating across borders within the EU (further information is provided in the box below).

European Union Financial Services Action Plan

The Financial Services Action Plan was set up in 1999 to provide a framework for progress to a single economic market in financial services and to provide impetus for EU member nations to implement the measures required to do so. The Action Plan was largely completed by its 2004 deadline, with 39 of its 42 measures having been adopted and the others being well advanced.

While significant progress has been made, difficulties have arisen that generally stem from the different starting points of member nations – nations had different traditions and approaches to banking supervision – and from differing national implementation of EU Directives. In the majority of cases, implementation of the Action Plan via directives rather than regulations has allowed for these variations in national adoption. An additional problem has been the failure of some directives to be incorporated into national law by all 25 member nations. By late 2005 only five measures had been incorporated by all member countries.

While complete harmonisation is unlikely to occur in the foreseeable future, there have been attempts by organisations such as the Committee of European Banking Supervisors to improve levels of harmonisation. The Committee has been issuing guidelines to achieve better alignment of supervisory practices and to improve information sharing and cooperation between supervisory agencies. The development of training and staff exchange programmes to create a more integrated supervisory culture has also been proposed.

The Committee views the implementation of the recently issued Capital Requirements Directive, which transposes the Basel II capital adequacy framework into EU law, as an important opportunity to improve convergence of standards and day-to-day practices in member nations.

The Australian and New Zealand response

Australia and New Zealand have also been tackling this issue over the last few years. The Australian and New Zealand banking markets are among the most highly integrated in the world – partly because of New Zealand's liberal policy towards foreign ownership of banks. Around 85 per cent of New Zealand bank assets are Australian-owned and New Zealand assets comprise around 15 per cent of the total assets of Australian banks. Some banks share systems across their Australian and New Zealand businesses. The same four banks are large and important in both countries.

The regulators, APRA and the Reserve Bank of New Zealand (RBNZ), have entered into formal and informal arrangements to enhance working relationships and cooperation. These arrangements include an MOU, a Terms of Engagement on the

implementation of Basel II and regular meetings. However, the need for change in the regulatory framework to better reflect the level of integration has been identified.

In 2004, the Australian and New Zealand Governments announced their desire to move beyond a free trade relationship, and take steps towards a single economic market. In the area of banking services, the near-term objective is to achieve a 'seamless regulatory environment'. This objective is important both for financial stability and efficiency reasons.

From a financial stability perspective, the actions of one supervisor may have implications in the other country which need to be considered. In addition, due to the high level of commercial integration, the fallout from any financial difficulties in the four major banks is unlikely to be confined to a single country – even if it originates in one country.

From an efficiency perspective, minimising regulatory compliance costs and inefficiencies has direct benefits for banks, consumers and investors. In addition, allowing banks to choose an optimal structure and operate efficiently is important if they are to remain competitive in an increasingly global financial services environment.

In light of the single economic market objective, the Australian Treasurer and New Zealand Finance Minister established the Trans-Tasman Council on Banking Supervision to promote a joint approach to banking supervision that delivers a seamless regulatory environment in banking services. The Council's aim is to facilitate the integration of the two markets to the greatest extent possible, while maintaining the safety, stability and efficiency of both financial systems and recognising that we are two sovereign nations.

In the first instance, the Council was asked to report on legislative changes that may be required to ensure that APRA and the RBNZ can support each other in the performance of their current regulatory responsibilities. The Council's terms of reference also require it to:

- enhance cooperation on the supervision of trans-Tasman banks and information sharing between respective supervisors;
- promote and review regular trans-Tasman crisis response preparedness relating to events that involve banks that are common to both countries; and
- guide the development of policy advice to both governments, underpinned by the principles of policy harmonisation, mutual recognition and trans-Tasman coordination.

At their annual bilateral meeting in February 2006, the Australian Treasurer and New Zealand Finance Minister announced that both governments had agreed to legislate the changes recommended by the Council.³

These legislative changes will ensure that APRA and the RBNZ can support each other in the performance of their statutory prudential responsibilities and, wherever reasonably possible, avoid actions that could have a detrimental effect on financial system stability in the other country. APRA and the RBNZ will also be required to consult each other on these matters.

The legislative proposals are a first step in creating a regulatory framework that better reflects the high degree of interdependence of our banking markets and will facilitate coordination beyond what can be achieved through mechanisms such as MOUs. The proposals do not aim to align the regulatory objectives, rules and approaches but rather allow the two countries' regulatory frameworks and regulators to operate with fewer points of potential friction (and have ironed out the most pressing issues in this regard). In addition, we have recognised that requiring each country's supervisor to explicitly consider what impact its actions have 'across the Tasman' can maintain or even enhance safety and stability, while allowing more efficient banking outcomes.

One such example is in relation to IT systems in banks. In a situation where a bank is in financial difficulty, regulators need access to the bank's systems to gain sufficient information on which to base decisions and, possibly, to implement the agreed course of action. It may be less costly, because of economies of scale, for each of the four major banks to run a single system from one site to support both its Australian and New Zealand operations. But this can create uncertainties for one regulator – as the systems are in a different jurisdiction, will they be assured access to them in a crisis? (This is an issue with any offshoring arrangement.) The legislation aims to provide comfort to both regulators that the other will not unduly interfere in the provision of centralised services to banks in the other country. Consequently, the regulators will be able to afford the banks greater flexibility in how they structure their businesses within the trans-Tasman market, which is expected to bring compliance cost reductions and efficiency benefits.

3 In Australia these changes are being progressed through the Financial Sector Legislation Amendment (Trans-Tasman Banking Supervision) Bill 2006, which was introduced into Parliament on 14 September 2006. Mirror legislation is also progressing through New Zealand's Parliament.

The future of cross-border banking supervision

A number of mechanisms are being developed to promote convergence of regulation and cooperation in cross-border supervision. But in many ways the world is still in the early stages of deciding how best to achieve the balance between allowing banks more freedom to operate internationally and maintaining safety and stability.

The approaches taken to date tend to emphasise harmonised minimum standards and coordination and cooperation between national supervisors. The Basel Committee has high-level principles relating to cross-border supervision. The EU model has harmonisation of certain rules and mutual recognition while maintaining separate country supervisors. The Nordic supervisory authorities have established protocols for cross-border crisis management. The trans-Tasman model is promoting coordination between APRA and the RBNZ but still allows for different regulatory frameworks and rules.

These are all significant steps towards addressing cross-border supervisory issues and will generate real benefits for the banking industry, consumers and regulators. But is it possible to achieve greater efficiency gains and promote greater safety and stability? If this is our goal, there are a number of difficult issues to address and significant hurdles to negotiate. It will be how these issues and hurdles are resolved, including the weighing-up of benefits and costs, that will determine the future path of regulation and the banking business environment.

International standards and codes

In recent times, significant effort has been devoted to the adoption and implementation of international standards. Many of the international standards have been adopted by the IMF and World Bank, which measure countries against them as part of their regular assessments. Australia has been a participant in and supporter of this process. These standards have an important influence on harmonising cross-border regulation.

In Treasury, we have begun thinking about two high-level issues relating to ensuring that international standards are of the best quality possible.

The first is, how appropriate are the processes and mechanisms for setting international standards?

A number of international standards – including the Basel Core Principles and capital accord – have been developed by international committees of national regulators. In many cases these committees were formed to consider a small number of specific issues and from that grew into a role in developing and promulgating standards to their members and other similar organisations. These committees clearly have expert

knowledge in their fields and a worldwide range of experiences to draw on in developing standards.

But given the importance that these international standards are assuming in domestic policy formulation, there is a question of whether policy makers – financial policy agencies like the Treasury and finance ministries – might add value to the process of determining international standards. At the domestic level, policy makers have a key role in developing and deciding on legislation.

The IMF (2004) paper *Financial Sector Regulation: Issues and Gaps* covers the state of implementation of international standards and raises issues with respect to the design of standards. One policy challenge raised by the IMF is that standard setters can have a narrow or specific focus, rather than financial system-wide view. We think that there is scope to increase the role of policy makers in the specific standards setting bodies – including where bodies of regulators set rules. This would bring a broader perspective – not just financial system-wide view but economy-wide – of the standards and should ultimately help to develop better standards.

The second high-level issue is the goal of the various international standards. In our view there are two main goals: setting out good regulatory practice to facilitate well-functioning markets (and confidence in those markets); and improving consistency in regulation across countries to assist cross-border business and flows, to reduce opportunities for regulatory arbitrage and to monitor contagion risks.

In general, these goals work in the same direction. However, some tensions have been recognised between the two objectives. The IMF, in the same paper mentioned previously, has noted that some standards can assume certain legal, policy and institutional conditions for financial sector regulation. These conditions may not be present in all countries and therefore the practices suggested may not be most appropriate. One response to this has been that standards often allow flexibility in implementation so that countries can adapt the standards to their own circumstances. However, as the IMF points out, there is a tension between allowing flexibility and the goal of international harmonisation.

We do not have answers to these tensions. However we consider that it is important for standard setters when determining international standards, and for national governments when adopting them, to address these issues thoroughly to ensure that the ultimate objectives are clear and that the correct balance is struck between the objectives.

For example, in Australia's implementation of International Financial Reporting Standards, a strategic decision was made that the Australian Accounting Standards Board be permitted to adapt an international standard if it is in the national interest to

do so. Judging when a domestic concern is weighty enough to warrant a deviation from the international standards is not always an easy task. Too many domestic deviations would undermine the benefits that flow from implementing the international rules.

Practical integration issues

There are also more ‘hands on’ or practical issues that arise in any circumstance where we wish to achieve greater integration of banking regulation across borders — particularly if the end goal is complete integration, such as one set of rules or one supervisory approach or, perhaps, one regulator.

Any international regulatory harmonisation encounters the issue of governments wanting to protect their sovereignty and national interests. Consequently, regulatory models that require governments to forego independent rule-making ability and independent responses to regulatory matters may not be attractive, and it is often difficult to convince constituents in all participating countries of the benefits (and, indeed, every country may not benefit from particular proposals). This is particularly so in an area such as banking regulation where the costs associated with a crisis can be substantial. It is here that those with an interest in achieving greater regulatory harmonisation have a role in advancing arguments for it and building support. Australia and New Zealand, being only two countries and having similar characteristics, should have a greater chance of achieving agreement than larger country groupings.

The issues of sovereignty and national interest often arise because of existing differences between countries, including their political structures and regulatory frameworks and philosophies. For example, in the trans-Tasman context, depositor preference plays an important role in determining the approach to supervision in Australia but New Zealand is not attracted to models that provide preference to national depositors over other bank creditors. To achieve one set of rules there would need to be compromises, on the balance of overall objectives where these differ in existing regulatory frameworks and on the instruments to achieve those objectives.

Even if these issues were overcome, implementing the same rules the same way in different countries can often be a challenge. Any differences that arise in implementation can reduce the benefits achieved from having the same rules. As was noted earlier, this has been an issue in the EU member states.

One method of encouraging consistent implementation is a single multi-country regulator or an overarching body above national regulators. This would require even closer cooperation and commitment between countries than a single set of rules and may only have limited practical applicability — such as in an economic and political

union like the EU and, possibly, Australia and New Zealand. Indeed, Australia and New Zealand have started down this path in other areas of regulation with the formation of the Trans-Tasman Accounting Standards Advisory Group and negotiations for a single regulator for therapeutic goods.

Then there are issues regarding governance, accountability and funding. A single set of rules or single regulator raises the governance questions of who the standard setting bodies or regulators are, who the members of the bodies are such that they fairly protect the interests of all countries, who appoints the members, and who resolves disputes. Accountability raises questions of who the bodies are answerable to – that is, can a single body function well if it answers to multiple parliaments or if individual members answer to different parliaments? The funding issues involve deciding who pays for the running costs of the standard setter or supervisor and who bears the potential costs of any crisis intervention or failure.

It is also the case that banking, and its regulation, do not operate in a vacuum. Other laws, such as taxation, insolvency, corporations and financial reporting, can have a large influence on the operation of banks. It may be that differences in these laws between countries can prevent banking prudential regulation from converging. Requiring other areas of law to converge before you can agree on one set of prudential rules for banking adds substantial complexity to the task.

Conclusion

These are difficult policy issues that pose challenges for decision makers and legislators. The European experience suggests that full integration can be a slow process and any efficiency and other gains may take time to materialise. Other areas of the trans-Tasman relationship show what might be possible.

The degree of business integration in the banking sector and the potential benefits of regulatory integration suggest that work to underpin a vision of a supervisory framework that reflects the level of interdependence of banking markets should continue. And indeed, with the Trans-Tasman Council on Banking Supervision still having major parts of its work programme ahead of it, we will continue to work with our New Zealand colleagues to ensure that our countries achieve the goal of a 'seamless regulatory environment'.

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