



BANK OF ENGLAND

Speech

Taming international banks: Time for some new tricks?

Speech given by

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Guest Lecture Series on International Finance, Harvard Law School, Cambridge,
Massachusetts

22 March 2016

I would like to thank Andy Murfin, Stephen Rutherford, and Tanveer Hussain for their help in preparing these remarks, as well as Ben King, Robert Hills, and other colleagues at the Bank of England for their helpful comments.

Some might compare international banks to lions. They have the potential to inflict great damage on others if not handled carefully. Our job as regulators is to tame these lions through our regulation and supervision – just like a lion tamer tames a lion.

Based on the experience of the last decade - a tumultuous one for the global economy and for the financial services sector in particular - our approach to taming these lions appears not to have worked terribly well. There were many underlying reasons for the global financial crisis. But the risks that came with international banking were certainly among them.

International banking is not inherently a bad thing – quite the reverse. We want an open global economy, with international trade in goods and services helping support global growth. International banking has a key role to play in supporting such growth, through financing trade and providing access to deep capital markets. It has justifiably become a cornerstone of our global economy, which thrives on openness, including in international financial and banking services.

But such openness makes domestic economies more vulnerable as a result of contagion and spillovers from shocks that originate elsewhere – whether from other international economies or global capital markets and the international financial system. In addition, when banking is international, it can generate problems of effective oversight and coordination, and so difficulties in ensuring a full understanding of the risks being run within that sector. To get the benefits of international banking safely, these risks need to be managed. We need to work out how to be better lion tamers to create a safe environment for all. And we should aim to get to the point where we are happy that even in a crisis it is safe to put our heads in the lions' mouths.

Globally, the regulators of financial services activity have been prominent in their response to the crisis. We have sought to improve the resilience of banking, domestically and globally, thereby supporting financial stability. But in pursuing this objective, we need of course to look at the costs as well as the benefits of our approach. We need in particular to ensure that that resilience and stability is not achieved at the expense of what might colloquially be described as the 'stability of the graveyard'. Put another way, we do not want to tame international banking to such an extent that it is unable in practice to support international trade and growth, or that it does so at too high a cost. We do not want the lions to be completely sedated.

My focus today is not on the improved regulatory standards for banks that have been set by the Basel Committee on Banking Supervision under the leadership of the Financial Stability Board and that have applied to all banks since the crisis. Rather my focus is on the who and the what of how we regulate international banks - those that operate across national borders – and in particular how in the absence of a single global banking regulator we can seek to ensure that the risks posed by these international banks are well managed. How the domestic regulators can work together to not just tame the risks facing their own economies, but the risks facing the global one – in the same way that lion tamers can work together.

Given the highly interconnected, dynamic nature of these firms, it makes for an interesting challenge. And it is one that interests the UK in particular given our perspective as host supervisor of around 170 international banks from over 50 jurisdictions, and including every one of the 30 Globally Systemically Important Banks (G-SIBs). I believe many of the changes that have been made provide a stronger platform to allow our approach to regulation to recognise the benefits whilst containing the risks of international banking in a balanced way.

In terms of “hosting” international financial services, the UK and the US are the two most important markets in the world. So as regulators we both have a major role to play in setting the tone and framework not only for financial stability in our own economies but also for our contribution to global financial stability. Today I will set out how we are taking forward host supervision of international banks in the UK— our ‘new tricks’ designed to address the risks. How do we, at the Bank of England, tame the risks that we face from international banks? What is our approach to taming these lions?

The benefits and costs of international banking

In absolute terms the UK and the US are by some measure the two largest host jurisdictions for financial services activity in the world. And if you scale activity relative to GDP, the UK is substantially larger than the US. UK banking sector assets have risen from around 100% of GDP to around 450% over the last 40 years – the corresponding figure for the US stands at around 70%¹. Not only that, but overseas banks comprise almost half of those banking assets in the UK². In comparison, US overseas banking assets as a share of total banking assets are around a fifth³. That means that the UK has three times as many assets from overseas banks as a share of GDP as does the US from all banks operating there. In addition we supervise in the UK more than a third as many assets from US banks as do US regulators from US banks operating in the US. Furthermore we have almost twice as much international banking activity booked in the UK as anywhere else. Understanding the benefits and risks of international banking matters a lot to us.

We also have a unique perspective given the range and nature of business undertaken in the UK. We are host to the largest investment banks, and to global capital markets trading activities in particular. This makes us and the US one of the most interconnected countries in the global financial system. Given the interconnectedness and potential complexity of the UK’s part of the financial system, its health undoubtedly matters a lot for global financial stability. But in addition we are host also to a great many firms which are neither focused on the domestic UK economy nor are they globally systemically important. These banks instead use the UK as a base for wholesale banking activity and trade finance whether their roots are in Europe, the Middle East, Africa, Asia or the Americas. This degree of interconnectivity between the UK and the rest of the world is such that the IMF noted in 2011 that, “the stability and efficiency of the UK financial

¹ Why is the UK banking system so big and is that a problem?; Bush, Knott, & Peacock; Bank of England Quarterly Bulletin 2014 Q4

² Prudential Regulation Authority Annual Report and Accounts 2015

³ Foreign Banks in the US: A primer; Goulding and Nolle; November 2012

system is a global public good due to potential spillovers and thus requires the highest quality of supervision and regulation”⁴.

As a major host to international financial services activity, we are highly attuned to the importance of international trade and international banking to a successful world economy. Openness and trade support economic dynamism through many different channels. They promote efficient allocation of capital and risk, support greater competition, utilise comparative advantage, expand the size of the global market, and build economies of scale.

International wholesale banking has a critical role in facilitating these flows, contributing to the efficient allocation of capital globally, and so developing the world economy. Trade finance is of course essential to support trade. Deep global capital markets benefit savers and borrowers from around the globe. International banking also brings benefits, such as diversification of risks, efficiency, competition, and the advantages of specialisation.

So, if those are the benefits, what about the potential risks of international banking?

The risks from banking are well known – that the failure of an institution can lead to contagion and spillovers that may have direct and indirect impacts on financial stability. These risks may be amplified, accelerated, and transmitted through the increased degree of interconnectedness that international banking brings. This could be through greater exposure to cyclical global macroeconomic trends, or through a greater appetite and capacity for risk without appropriate controls.

Successive crises have clearly demonstrated the effects of international banks, and capital markets, ‘freezing’. Contraction in credit supply is a powerful channel through which financial crises hit global and domestic economies. And the balance between international and domestic services can shift rapidly in a recession as international banks serve the home market. In 2008-09 for example, UK resident banks cut cross-border lending by 30%⁵, significantly more than lending in the UK. The same patterns were seen internationally. Lehman of course had global effects, but numerous other entities had substantial cross border effects too. The crisis showed us all too clearly that international banking, interconnectedness, and unrestricted capital flows carry risk as well as rewards.

All this underlines the importance of delivering effective oversight of international banks. Prudent international regulatory standards are a necessary part of this, but are not on their own sufficient. Rather we need effective supervision as well, something that is inevitably harder given the cross border nature of the activity and the potential both for gaps and for different priorities. That creates a need for close cooperation

⁴ Spillover Report on the United Kingdom for the 2011 Article IV Consultation; Country Report No. 11/225; IMF; July 2011

⁵ Understanding international bank capital flows during the recent financial crisis; Hoggarth, Mahadeva, Martin; September 2010

between both home and host supervisors to deliver effective global consolidated supervision of international banks.

The changing approaches we've seen since the crisis

There is a spectrum of approaches that supervisors can take to the supervision of international banks. In the absence of a single global consolidated supervisor, let me describe the two logical extremes.

First one can have a model of pure home supervisor responsibility, based on branches of the parent group and where the host supervisor relies completely on the home supervisor. By allowing the most rapid allocation of capital around the globe, this model delivers the greatest benefits. But it simultaneously creates the greatest risks to financial stability in host countries because of the potential lack of clarity of remit, information, and responsibility and powers to deal with the risks international banking brings.

Alternatively one can have a pure host-led approach. This would require operations overseas to be undertaken in subsidiaries, with those subsidiaries supervised in the same fashion as domestic banks, in effect treating the overseas entity as independent and standalone. This model reduces the risk of an abrupt cessation of financial services following events overseas and so, at first sight, does a better job of protecting financial stability. But it makes the cost of entry much higher. And the threat of contagion from the parent may remain anyway.

There are of course a myriad of shared approaches between these extremes as well. What have we seen in practice?

I would describe the approach in the run up to the crisis as one of **fragmentation** – with host supervisors focused on local risk in local entities and home supervisors unappreciative of some of the risks taken overseas. Host supervisors did not fully consider risks from the parent group. Information sharing was fitful. Colleges - gatherings of relevant supervisors - were fairly rudimentary. And while there were some attempts to increase home-host coordination, in practice there were material gaps. This meant that neither host nor home supervisors had sufficient information to assess the risks to domestic financial stability posed by overseas firms.

A key lesson we learnt in the crisis as host supervisor was the manifestation of global risks in local entities, and the importance of home-host information sharing and coordination. For example on the wholesale side, Bear Stearns and Lehman both saw problems occur outside their UK operations, where we had little sight of developments, and which led to uncertainty, loss of confidence and a flight of short term wholesale funding. Similar issues arose on the retail side, where some overseas banks had taken significant amounts of retail deposits very quickly whilst others had provided significant lending to UK borrowers. As host supervisors we learnt all too clearly the need to get sufficient detail on the significance of overseas banks' branch activities to

understand their potential impact on UK financial stability, the need to understand the major risks run by a global parent and the impact that might have on UK operations, and the potential need for early supervisory intervention.

In the immediate aftermath of the crisis, and reflecting these lessons, there was a change in approach from this fragmentation to regulatory **balkanisation**. This approach is aligned with the pure host-led model I described earlier and is based on the premise that host entities should be clearly separable and separated from their parent group. At the extreme, this treats local subsidiaries in isolation from the parent group, with a sufficient local pool of capital and liquidity so that it is self-sustainable in the event of failure, ensuring that the entity can be resolved on its own.

On the face of it, this provides for domestic financial stability. However, it is not without cost. The benefits of international trade and capital flows are reduced. Total global capital requirements are higher since the benefits of diversification in international banking are not recognised. And how realistic anyway is the premise of self-sustainability at the individual country level for businesses that are inherently global and closely integrated - as opposed to groups that represent in effect a collection of standalone retail banks.

Views on that judgement need in my view to be taken in the round alongside the other regulatory changes that we have seen since the crisis. The subsequent post crisis response has been centred on putting in place the right prudential standards to improve resilience globally and locally. This has meant banks cutting leverage, raising capital, raising liquidity, and providing for better governance, risk management, and disclosures. Global financial stability has also been targeted through having greater requirements for globally systemically important institutions.

Beyond resilience, one of the other tenets of our post-crisis regulatory reform agenda has been to address 'too big to fail' by ensuring institutions are resolvable. The intention behind this work on resolution is to create a coherent and deliverable approach to resolving banking entities – either together as a group through so-called "single point of entry" resolution, SPE, of the whole group; or through "multiple point of entry" resolution, MPE, where local entities or regional subgroups are treated as standalone and can be resolved in isolation from their group⁶. Effective resolution is a cornerstone for providing confidence that capital and liquidity will be moveable in a stress to where it is needed rather than needing to be prepositioned in case stress arises. Resolution is also supported by additional total loss absorbing capacity (TLAC) requirements on firms to absorb losses and recapitalise as needed in the event of a resolution.

The balkanisation that was the initial response of regulators to the crisis supports locally-led, uncoordinated resolution. Strong local requirements are in place to ensure multiple local resolutions of failed entities.

⁶ Authorities and firms have a choice in resolution planning. The choice of resolution strategy will depend on several factors. What is the firm's business model; how separable are the local entities and their businesses; to what extent do they share common critical services and common management; how can these best be managed in resolution.

However, this is likely to be a suboptimal outcome for all concerned. Local entities and the critical functions they provide may not in reality be able to survive resolution separated from their parent. Furthermore, uncoordinated actions by authorities increase the risk of ‘asset grabs’ and a general need for more resources across the group as a whole. Coordinated resolution, and for highly integrated groups an SPE strategy, can better support international banking and international capital flows. With coordinated resolution, the need for regulatory balkanisation can be reduced, with host supervisors reassured by an *internal* TLAC requirement that transforms debt into equity and so ensures capital resources can be down-streamed from the parent group in a stress when needed, rather than pre-positioned ‘just in case’.

Let me return now to the key lesson we took as host supervisors from the crisis – that of our greater appreciation of the connectivity between the entities we supervise and their parent groups. This is present in franchises and business models, in financial exposures and in operational support. And it means that for the largest, most systemic entities in particular, in all likelihood the subsidiary will not survive the death of its parent. (For that matter, it is likely also that for many groups neither would the parent survive the death of a major subsidiary). This suggests that, as well as a coordinated approach to resolution (with SPE for highly integrated firms) so we need also to have close and committed supervisory cooperation.

The third phase: how we take international supervision forward

The post-crisis regulatory reforms have, I think, laid the foundations for a constructive and integrated approach to national supervision of international banks - one that can take us away from the initial response of regulatory balkanisation and towards what I have termed **committed cooperation**.

Given the benefits that international banking brings, we are keen to be open for business, provided that business is undertaken safely. But what’s safe depends on what business is being carried out, what legal entity it’s carried out in, and what policy regime applies to those entities.

For example, we have a clearly articulated risk appetite for activity undertaken in non-EEA branches, published in 2014. Our appetite is not limitless. It is driven by the equivalence of the home regulator, an appropriate agreed split of responsibilities with the home regulator, and assurances over resolution from the home regulator which embeds a coordinated approach to resolution.

We pay close attention to the activities carried out within the branch, particularly if such activities are important to UK financial stability. We are clear that we do not wish to see branches undertaking critical retail banking functions (like taking transactional deposits) beyond a minimal level unless there is some good reason and importantly a very high level of assurance on resolution. But the approach also recognises that some activities may be important to global financial stability, so putting a domestic wall around them may be counterproductive. And we recognise that we need to play our part in host supervision of branches by

supervising their effects on UK and global financial stability, their effects on the group and by working with the home regulator.

More broadly, and reflecting the concentration of global capital markets and trading activities in the UK, we have a responsibility to look at capital market developments and deliver good supervisory outcomes for the firms involved in order to support global financial stability. Much of this activity takes place in subsidiaries. But given the way trading firms in particular are structured, we often see only part of the risks run in particular books. Booking models are such that the UK may have the global book for some products but only part of the book for other businesses. And while we of course want sensible transparent booking models based on a coherent business and risk management rationale (as opposed to an arbitrary - or worse an arbitrated - allocation of business) we will still need to work closely with the home regulator to share understanding of the risks being run. We also need to remember that the business model, financial and operational connectivity between the entities we supervise and their parent groups means that in all likelihood, as with Lehman, the subsidiary will not survive the death of its parent. So we need to work closely with the home regulator to gain appropriate insight into risks run at the group level.

We therefore seek to adjust our approach to supervision for those international groups that are highly integrated. In particular since the links between them mean that they are not separable in any meaningful sense of the word, we support SPE resolution for such firms. In addition we aim both to judge the risks of the UK entity in the context of the global group, and to judge the risks to the UK entity from the global group. And as with branches, we play our part as host supervisor of subsidiaries by supervising their effects on UK and global financial stability and by working with the home regulator.

We do have expectations of the local business. Whilst recognising that subsidiaries are not fully independent of the group, we would not expect them to be designed to be structurally loss making. And we expect subsidiaries to be capable of accreting a portion of their own capital, rather than being fully dependent on a drip-feed of capital from the parent, as this creates poor incentives and can become problematic if the parent gets into trouble. We expect high standards of governance (including clear accountability for the management of local entities via the new Senior Manager's Regime) and risk management, consistent with these firms' importance to the financial system.

At this juncture we have chosen not to apply either domestic system wide stress tests or local capital buffers to reflect the systemic importance domestically of these institutions. We instead seek to develop close dialogue and greater information sharing with the home regulator on the stress exposures they see for the group as a whole, and to allow us to judge how these will affect the UK entity.

All this is cooperation. But what about the risk that this coordination and insight might disappear, particularly in the event of stress? How do we create committed cooperation? In that event, the ability to set internal TLAC is key. By turning debt into equity in the event of stress, internal TLAC gives host supervisors the

ability to upstream losses in bad states of the world and so creates a binding commitment to downstream capital from the group when it is needed. Together with supervisory cooperation internal TLAC ensures the home regulator is fully sighted on and committed to act to mitigate financial stability risks inside the host country. It can credibly act as a counterweight against the host supervisors' natural desire for higher local equity capital to be pre-positioned. At the same time internal TLAC can also help to ensure that there will be sufficient locally held capital to enable an orderly wind down of that entity in the event of stress.

This approach recognises the integrated nature of many international groups. It recognises that having a clear agreed resolution strategy, combined with committed cooperation including in-depth sharing of information between the home and host supervisor, is key to understanding the risks that are shared by the parent and subsidiaries of large, complex groups. But it also seeks to ensure that the potential risks of a disorderly resolution are mitigated.

In summary there are a number of key components to committed cooperation.

- a. A credible resolution strategy and equivalence of the home resolution regime, supported by internal TLAC.
- b. A high degree of commercial, operational, and financial entanglement between subsidiary and parent.
- c. Transparency over the financial position of the parent group, its capacity to support the subsidiary, and the equivalence of the home supervisory regime.
- d. Transparency over the intervention framework, including host and home discretion and triggers for action.

If we can move to a position where sufficient and appropriately committed loss absorbing capacity is in place on a global basis in order for these groups to deliver outcomes for both home and host supervisors, then we will be better able to realise the benefits of international banking – and to do so safely.

In conclusion, international banking benefits the global economy. However it carries risks. And because of their cross-border nature, international banks are inherently harder to supervise due to the risk of duplication and gaps. There is in addition a danger of international banks being supervised sub-optimally in a balkanised manner. As the largest host supervisor globally by many measures, the UK is more exposed to these risks than most.

In my view the best approach to try to tame these risks is to act globally, through committed cooperation between home and host supervisors. We can get to the point where we are not in fear of international banking, and that the risks that it brings are appropriately managed – just like a lion tamer controlling their lions – and under control. As host supervisors we are committed to playing our part in global consolidated supervision and resolution of international banks. This supports international banking and flows of capital – and supports a strategy of being 'open for business' as long as it is safe.