GENERAL PRINCIPLES OF LAW UNDERLYING AN INTERNATIONAL REGIME FOR THE PRESERVATION OF BANKING STABILITY

Paper presented at the dinner delivered by the Hellenic Bank Association during the 96th meeting of the Legal Committee of the Banking Federation of the European Union

Christos Gortsos

Secretary General, Hellenic Bank Association

June 5th, 2003

A. Introduction

Regulatory failure, along with market developments, can induce the fragility of international banks and the international financial system. Taking account of these aspects, and given also the potential for the contagious transmission of banking failures in several jurisdictions, efficiency gains can be achieved by creating an international regime for the preservation of the stability of banking systems.[1]

(a) The effectiveness of such a regime depends on whether national bank supervisory authorities and other authorities entrusted with particular aspects of banking stability are willing to cooperate, coor-dinate their policies, and make binding arrangements in order to preserve stability and contribute to the safety and soundness of the international banking system.

(b) The above mentioned arrangements should seek to prevent the two sources of national regulatory failure in international banking: **competitive deregulation** and **regulatory externalities**.

(i) The parties to an international regulatory regime should seek to prevent, firstly, competitive deregulation among national authorities. To do so they must agree on implementing adequate prudential and protective measures to control the insolvency exposure of international banks and prevent chain reactions of failing banks.

(ii) In order to deal with regulatory externalities, an international regime should also ensure that all banks with foreign-based operations are under components of the bank safety net[2] of at least one sovereign state and no foreign establishment of international banks escapes regulation. In particular, internationally engaged depository institutions should submit to the

[1] For the purpose of this presentation, a regime is defined as the set of principles, norms, rules and decision-making procedures, implicit or explicit, around which expectations converge in a given issue-area.

[2] The bank safety net can be viewed as a series of circuit breakers designed to prevent a shock to one part of the banking system from surging through the financial network to damage the rest of the system. Its components include:

- entry requirements,
- prudential supervision,
- the winding-up and reorganisation of unviable banks,
- deposit guarantee, and
- lender of last resort facilities.

These components are also considered as prudential and protective regulatory measures.

jurisdiction of at least one national or supranational authority with regard to each component of the bank safety net.

(c) In order to reach these operating targets, the sovereign countries participating to the regime must agree on the introduction of adequate procedures. In particular, they must decide on the prudential rules to be enforced (*see* B below) and determine which authorities should be responsible for implementing them (C below).

B. Applicable Law

1. Introduction

In order to overcome the problems arising from competitive deregulation, the parties to an international regime must determine what rules are to be imposed, implemented and enforced on the foreign establishments of international banks. Three alternatives can be taken into consideration:

- application of home country rules (*see* 2 below);
- application of host country rules (*see* 3 below);
- harmonisation of national rules as to their level and extent (*see* 4 below).

International agreements on prudential and protective banking regulations should raise similar questions to the ones referring to the issue of competent authorities:

- Entry requirements: under what conditions should foreign banks be allowed to enter the market of the host country ?
- Prudential supervision: which rules should govern the prudential supervision of foreign banks operating in a host country ?
- Winding-up and reorganisation: how should one deal with the termination of unviable, internationally engaged banks ?
- Deposit insurance: under what conditions should the depositors with a failing bank operating in a host country be compensated ?
- Lender of last resort: what rules, if any, should govern the provision of last-resort lending to foreign banks in the host country ? [3]

[3] Based on the principle of "constructive ambiguity", there is no provision in the charter of any central bank stating explicitly its role as a lender of last resort and the rules which would govern this competence.

Each of these questions must be dealt with separately for the foreign branches and subsidiaries of international banks. The situation is more complex in the case of branches because branches, though located and operating in a host country, are an integral part of banks located in the home country. Thus, by their very nature, branches are subject to conflicting regulatory regimes that can be reconciled for the most part only through harmonised rules.

2. Application of Home Country Rules

Under the "equity approach" the regulatory framework applied to the parent bank should also be extended to its foreign-based establishments in host countries. This implies enforcement of home country regulations in the host country. Two principles have been developed accordingly: the principle of mutual recognition, and that of treatment comparable to that of the home country. In application of both theses principles it is possible that foreign banks be treated more favourably than domestic banks in the host country.

(a) Mutual recognition of rules: according to the principle of mutual recognition, the host country assumes the obligation to accept the validity of the rules issued in the home country.[4]

(b) Treatment comparable to that of the home country: under this principle, the regulation of foreign banks in the host country is governed by home country rules.

3. Application of Host Country Rules

Under the "neutrality approach" all banks, domestic and foreign, established in a country should be subject to its regulations. This can be achieved by application of either of the following principles: national treatment, effective market access, and non-discriminatory treatment.

(a) National treatment: under the principle of national treatment, foreign banks in a host country are treated under *«laws, regulations, and administrative practices no less favourable than that accorded in like situations to domestic enterprises.»* This implies that they have the same opportunities and are subject to the same obligations as domestic banks.

[4] The principle of mutual recognition has been adopted by European Community institutions with regard to the authorisation of credit institutions (Directive 2000/12/EC), the prudential supervision of credit institutions (*ibid*), the winding up and reorganisation of credit institutions (2001/24/EC) and deposit guarantee schemes (Directive 94/19/EC).

(b) Effective market access: this principle implies application of the principle of national treatment. However, it also imposes on the host country the obligation for progressive liberalisation of its domestic laws and regulations.[5]

4. Harmonisation of National Regulations

Harmonisation of national laws can enhance the efficiency of prudential and protective regulations and help create conditions of competitive equity among international banks established in countries with different regulatory systems. Harmonisation may result from binding rules issued by an international organisation to which the parties to the regime have delegated authority. It can also be the by-product of non-binding agreements respected by the competent authorities of the countries concerned.

Harmonisation can be so extensive as to cover all aspects of a relevant issue-area (*e.g.*, all aspects of prudential regulation) **(full harmonisation)** or cover some of its aspects only (*e.g.*, capital adequacy regulation) **(limited-scope harmonisation)**.

In both cases, harmonisation can either cover entirely the components of the issue-area/ or the chosen component **(maximum harmonisation)**, or cover them only to a certain extent **(minimum harmonisation)**.[6] In the second case the national authorities can impose stricter rules on banks operating in their territory. The combination of full and maximum harmonisation leads to **total harmonisation**.

C. Competent Authorities

1. Introduction

A decision concerning which authorities should be responsible to enforce rules is also necessary in the context of an international regime for the prudential and protective regulation of international banks. It is necessary in order to ensure that no foreign-based establishment of international banks, whether a branch or a subsidiary, escapes prudential regulation. The issue on the determination of the

[5] The principles of national treatment and effective market access have been adopted by the General Agreement of Trade in Services (GATS) of the World Trade Organisation with regard to the provision of financial services as specific commitments of its member states.
[6] Minimum harmonisation is the main tool used in the context of Community financial legislation.

competent authorities is essential, even if harmonised rules have been adopted, because harmonisation cannot *per se* guarantee the quality of prudential and protective regulation. In this respect, two alternatives can be taken into consideration: either delegation of powers to a supranational authority (*see* 2 below), or division of responsibilities between national authorities (*see* 3 below).

Discussion on the division of responsibility among national authorities is usually confined to determining which authorities should be responsible for granting authorisation and which should be responsible for the prudential supervision of international banks. However, in the light of the previous discussion, it is considered appropriate to break the issue down into as many cases as there are circuit-breakers in the bank safety net.

An international agreement on prudential and protective banking regulation, should then raise questions similar to the ones referring to the issue of applicable law. In particular:

- Entry requirements: which regulatory authority should decide on the authorisation of foreign banks in the host country ?
- Prudential supervision: which regulatory authority should carry out prudential supervision of the foreign-based operations of international banks. Should the same authority be responsible for monitoring the solvency and the liquidity of foreign banks ?
- Winding-up and reorganisation: which regulatory or judicial authority should decide upon the closing down and liquidation of an international bank's foreign establishments, or upon the implementation of reorganisation measures ?
- Deposit insurance: which insurance fund should cover the depositors of an international bank in a host country if that bank has to be closed down ?
- Last-resort lending: which monetary authority should provide emergency liquidity assistance to international banks facing liquidity problems in the host country ?

The distinction between branches and subsidiaries is also neces-sary in this context. As a rule, however, subsidiaries can be submit- ted under the jurisdiction of host country authorities, since they are independent legal entities incorporated under the laws of the host country.

2. Supranational Authorities and Institutions

The competence to regulate international banks can be delegated by sovereign states to a supranational authority. Such a delegation requires an international agreement among states with regard to:

- a supranational supervisory authority responsible for the licensing and prudential supervision of international banks,
- a supranational authority for the termination of unviable international banks (including a supranational bankruptcy court),
- a supranational deposit guarantee fund, and/or
- a supranational lender of last resort.[7]

3. Division of Responsibilities among National Authorities and Institutions

The second alternative is to divide responsibilities among home country and host country authorities. In this case, it is necessary, on the one hand, to establish close cooperation between these authorities (or schemes in the case of deposit guarantee) and, on the other hand, provide for the dissemination of any relevant information. In theory, the subject matter of responsibility for foreign-based operations of international banks can be regulated under two main principles: the neutrality principle and the equity principle.

(a) Under the "neutrality principle" (or host country rule) all banks established and operating in a country should be subject to regulatory parity. This implies that prudential and protective regulations must be enforced by the host country authorities equally on both domestic and foreign banks. The host country rule seems to be the most appropriate solution for the regulation of the foreign subsidiaries of banks. [8]

---

[7] Under both international and Community legislation no such a supranational authority or deposit guarantee scheme has been established up to the present days. Even the European Central Bank is not a supranational supervisory authority (Treaty of the European Community, article 105, par. 5).

[8] The host country rule has been adopted with regard to the prudential supervision of the liquidity of foreign-based branches of international banks by both the Basle Committee on Banking Supervision under the provisions of the Amended Basle Concordat (1983), and Community legislation according to the provisions of Directive 2000/12/EC (for the prudential supervision of liquidity credit institutions). The same rule applies to the authorisation and prudential supervision of the foreign-based subsidiaries of international banks (according to both international and Community law).

(b) On the other hand, the "equity principle" (or home country rule) requires that the foreign branches and subsidiaries of international banks should be submitted to the jurisdiction of the competent authorities in the country of incorporation of the parent bank. Hence, the home country authorities should be responsible for enforcing the appropriate prudential and protective regulations on the foreign-based establishments of international banks incorporated in their jurisdiction, no matter these are harmonised or not.[9]

The competent authorities of either the home or the host country will be required to enforce the rules decided upon to govern the prudential and protective regulation of international banks, according to the consideration presented above. This implies the following:

(a) If the parties to the regime have not reached agreement on harmonising a particular component of the bank safety net (and to the extent that harmonisation does not cover the whole subject-area), the competent authorities will implement and enforce national rules. Depending on the content of the agreement concerning applicable law, the following possibilities arise:

(i) **Mutual recognition of rules**: responsibility for application of the rules lies with the home country authorities.

(ii) **Treatment comparable to that of the home country**: the host country authorities are required to enforce upon the foreign banks established in their jurisdiction home country rules.

(iii) **National treatment, effective market access, non-discriminatory treatment**: in all these cases, foreign banks in the host country are subject to the jurisdiction of host-country authorities applying domestic rules.

[9] The home country rule has been adopted, with regard to the prudential supervision of the solvency of foreign-based branches of international banks, by the Basle Committee on Banking Supervision under the provisions of the Amended Basle Concordat (1983). The same principle has been adopted by Community legislation according to the provisions of Directive 2000/12/EC (for the authorisation and prudential supervision of solvency of credit institutions) and Directive 94/19/EC (with regard to deposit guarantee schemes).
With regard to the foreign-based subsidiaries of international banks, the home country rule leads to the application of the principle of consolidated supervision which has been adopted by both the Basle Committee (under the provisions of the Amended Basle Concordat, 1983) and Community legislation (Directive 2000/12/EC).

(b) If, on the other hand, the regulatory measures are harmonised, the national authorities will apply the harmonised rules. However, in the case of minimal harmonisation, the national authorities will be allowed to implement and enforce their domestic rules to the extent that these are more stringent than the harmonised ones.

If responsibility for the prudential and protective regulation of international banks is divided between the authorities of the host and the home country these authorities should overcome several difficulties, such as conflicts of jurisdiction, conflicts of interest and various legal obstacles. In order to overcome these problems, an agreement on the division of responsibilities between national authorities must be accompanied by arrangements about their close cooperation. In addition, the transfer of all information on the regulation of international banks among national authorities must be facilitated.