Outline

- Impediments to supervisory coordination
- Coordination, Banking Profits and Economic Welfare

Practice versus Principles

- Establishing Principles is Straightforward
- Practical Implementation is Problematic
  - A multilateral rather than bilateral issue
  - US decision to apply Basel I to most banks
    - Different risk weights for branch v subsidiary in a Basel II host country?
  - Differences in legal and institutional arrangements, transparency, and possible reliance on Pillar 3
  - Differences/limitations in safety net arrangements (deposit insurance coverage of foreign branch customers)

Costs and Benefits of Supervisory Cooperation and Coordination

- A major issue is host country supervision of banks with Advanced IRB status in their home country
  - Host country regulatory capacity
  - Dual accreditation of systems
- Use this as an illustrative example to draw out some issues

The Effects of Non-Coordination

- What is the cost to multinational banks and host countries from imperfect supervisory coordination?
- Potential metrics include
  - Less effective prudential supervision / more risk of failure
    - (not a major issue in the example considered here)
  - Efficiency of financial intermediation
  - Banking sector competition and structure
  - Bank costs and profits

Efficient Financial Intermediation

- What is the social cost if a subsidiary of a multinational bank with home country regulation of Advanced IRB faces host country use of Standardised Approach?
  - Regulatory reporting/ compliance requirements differ
    - Relatively trivial
  - Subsidiary has higher capital requirement
    - Profitability and market competition effects
      - Efficiency or re-distributive?

Efficient Financial Intermediation

- The objective of better risk management systems (RMS) is better risk assessment, management and pricing, not lower capital
  - *Example*: a "one bank economy" with a fixed population of borrowers
    - Poor RMS – can't distinguish good and bad risks
    - Good RMS – distinguish and properly price risks
    - Outcome – total risk bearing by bank, and economic capital, is unchanged, but higher profit
      - *A caveat: loan composition may change and affect total risk bearing*

Efficient Financial Intermediation

- If better RMS are value adding they will be used internally anyway for risk assessment and management, regardless of the regulatory reporting and capital requirements.

Banking Sector Competition and Structure

- Better RMS provide a competitive advantage to their users
  - Better identification and pricing of risks
- Lower Advanced IRB capital requirements provide an extra competitive advantage
  - Risk of failure may be lower, but how does the social cost of failure of a large "advanced IRB" bank compare to that of a smaller "standardised approach" bank?
    - Policy needs to reflect both risk of failure and (social) costs of failure

Banking Sector Competition and Structure

- The Paradox
  - Basel II initiated to better align regulation of complex multinational bank wholesale activities with internal risk management systems
  - Competitive effects from reductions in capital charges for advanced IRB banks appear greatest in relatively simple retail financial markets
- Host country prudential regulators should consider competitive and market structure effects.

Bank Costs and Profits

- Naturally, individual banks will seek out every competitive advantage possible
  - Including those arising from the design and interaction of regulatory systems
- Spreading costs of, and extracting benefits from, RMS development over a larger multinational customer base is a reasonable objective

Bank Costs and Profits

- Benefits gained /costs recouped by using better RMS for loan pricing and management
  - even if regulated under standardised approach and given no capital concessions in a host country
- Resulting regulatory capital requirements may not be "optimal"
  - But few countries properly price benefits provided to banks from deposit insurance/implicit guarantees

Conclusion

- Regulatory ability to assess advanced RMS is desirable and necessary to facilitate banking sector development
- Host regulators in emerging markets may have quite valid reasons for not allowing multinational entrants the capital benefits of advanced IRB status available in their home markets
  - NB implications for form of entry (branch/subsidiary)