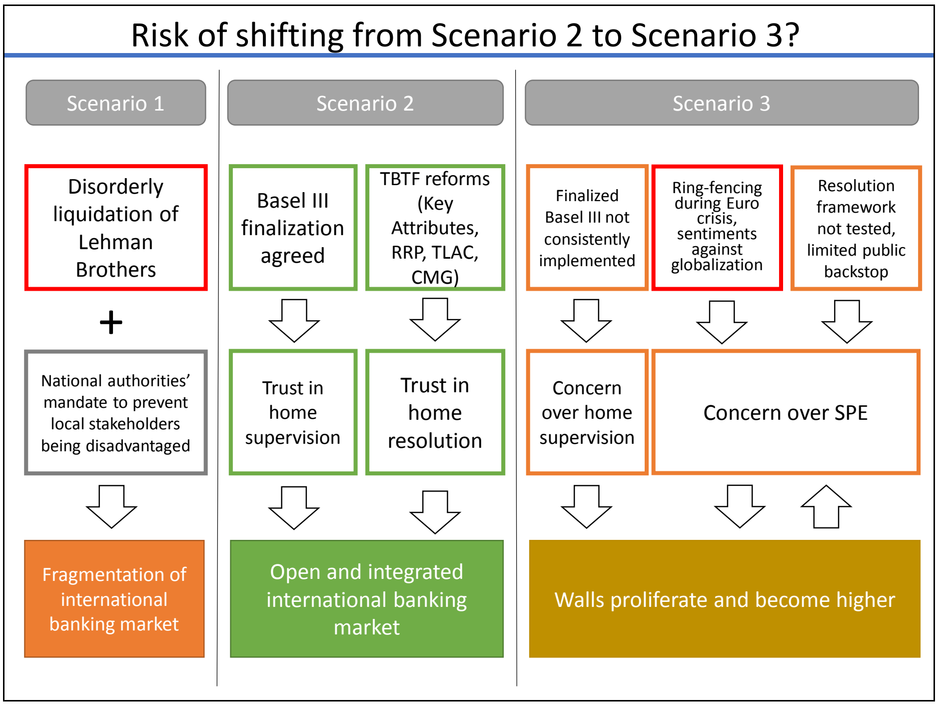
Four Scenarios about Fragmentation of the International Banking Market

Panel remarks by Ryozo Himino, Vice Minister for International Affairs, Financial Services Agency, Japan, at the Financial Stability Board Workshop on Pre-Positioning, Ring-Fencing and Market Fragmentation, Philadelphia, on September 26, 2019

The G20 Leaders declared in Osaka in June 2019 that they will address unintended, negative effects of market fragmentation. The FSB report on market fragmentation[1] submitted to the G20 earlier in the month identified "jurisdictional ring-fencing and pre-positioning of financial resources by international banks" as one of the four areas for further work. The FSB held this workshop to take forward work on this issue.

At the workshop the FSB held in Basel in January 2019, many participants pointed to the importance of the issue of jurisdictional ring-fencing and pre-positioning, but many also agreed that successfully addressing harmful fragmentation resulting from those may be the highest hanging fruit among the various market fragmentation issues. The June FSB report on market fragmentation analyzed ring-fencing and pre-positioning, but did not propose specific solutions. Hence this exploratory workshop.



[1] FSB (2019), *Report on Market Fragmetation*, 4 June.

In the spirit of exploration and stimulating discussion, rather than to repeat what is already in the report, let me lay out four hypothetical scenarios about greater or lesser fragmentation of the international banking market and a series of unproven propositions. I am not presenting an FSB view.

Let me start with what I call Scenario 1. I believe the disorderly liquidation of Lehman Brothers, given that national authorities are mandated to ensure that local stakeholders are not unfairly disadvantaged, could have resulted in a series of measures that could have yet greater fragmentation of the international banking market or even the end of international banking.

But this scenario was averted by enormous efforts both on the regulatory and the resolution front. As a consequence, the world shifted toward what I call Scenario 2.

The global regulatory community succeeded in finalizing Basel III in 2017 and created a basis for trust in home supervision.

Also, implementing the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions ('Key Attributes'), resolution authorities gained necessary legal power. Recovery and resolution plans (RRPs) have been prepared, TLAC issued, and Crisis Management Groups (CMGs) formed. These reforms must have worked to strengthen trust in home resolution, and continued efforts by resolution authorities, coordinated through FSB's Resolution Steering Group (ReSG), will further this achievement.

Enhanced trust in home supervision and trust in home resolution should work together to protect open and integrated international banking market, and I am not too much worried about the current level of fragmentation.

However, I am somewhat worried about a potential future direction, or the possibility of shifting towards what I call Scenario 3.

There are several potential driving forces for Scenario 3. First, though I believe we will see full, timely and consistent implementation of the finalized Basel III in 2022 across the globe, in case it does not happen, it would give rise to concerns about home supervision. The progress so far has not been too encouraging: Eleven specific standards were agreed between the initial Basel III and the finalized Basel III. They all should have been implemented by now, but Japan has implemented only nine, and both Europe and the United States four. We need to stay vigilant.

In addition, bank failures and supervisory ring-fencing during the Euro crisis period may have worked to undermine the trust between authorities. Also, sentiments against globalization are growing in many places in the world.

And after all, the new resolution framework has so far not been applied to a globally active financial institutions. The availability of public backstop is highly restricted in many jurisdictions, and whether the available backstop is sufficient to support orderly resolution is yet to be tested.

Let's take the case of liquidity backstop. The FSB Principles on Funding[2] state that "credible public backstop mechanisms should be in place to enable the temporary funding needs of the firm to be met to the extent necessary to maintain the continuity of critical functions in resolution" and that "any provision by authorities of temporary funding should be subject to strict conditions that minimise moral hazard." Even if we have enough TLAC to recapitalize troubled G-SIBs, if liquidity can be provided only against deeply haircut value of collaterals, it may be difficult to secure public and market confidence in the recapitalized new entity during the transition phase. Such arrangements would minimize moral hazard, but may fall short of maintaining the continuity of critical functions in resolution.

These factors can work together to give rise to the question of whether a single point of entry resolution strategy (SPE) can be effectively executed in an actual resolution scenario.

Concerns over home supervision and over the effectiveness of SPE may result in a proliferation of walls along national borders. A feedback loop can make walls higher and higher: If countries trap more resources within their borders, concerns over the practicality of SPE could grow further. Also, walls could become longer and longer: if a major jurisdiction builds walls, others may follow.

In the extreme scenario that this process transforms global systemically important banks (G-SIBs) into franchised networks of local-funding, local-lending banks, orderly resolution based on multiple point of entry strategy (MPE) would become much easier, but the international banking system's core function of allocating savings to global investment opportunities could be significantly weakened. On the other hand, if countries are emboldened by the existence of walls and start multiple local resolutions while a G-SIB continues to be a group of interdependent banks, such uncoordinated actions across different jurisdictions could result in disorderly resolution.

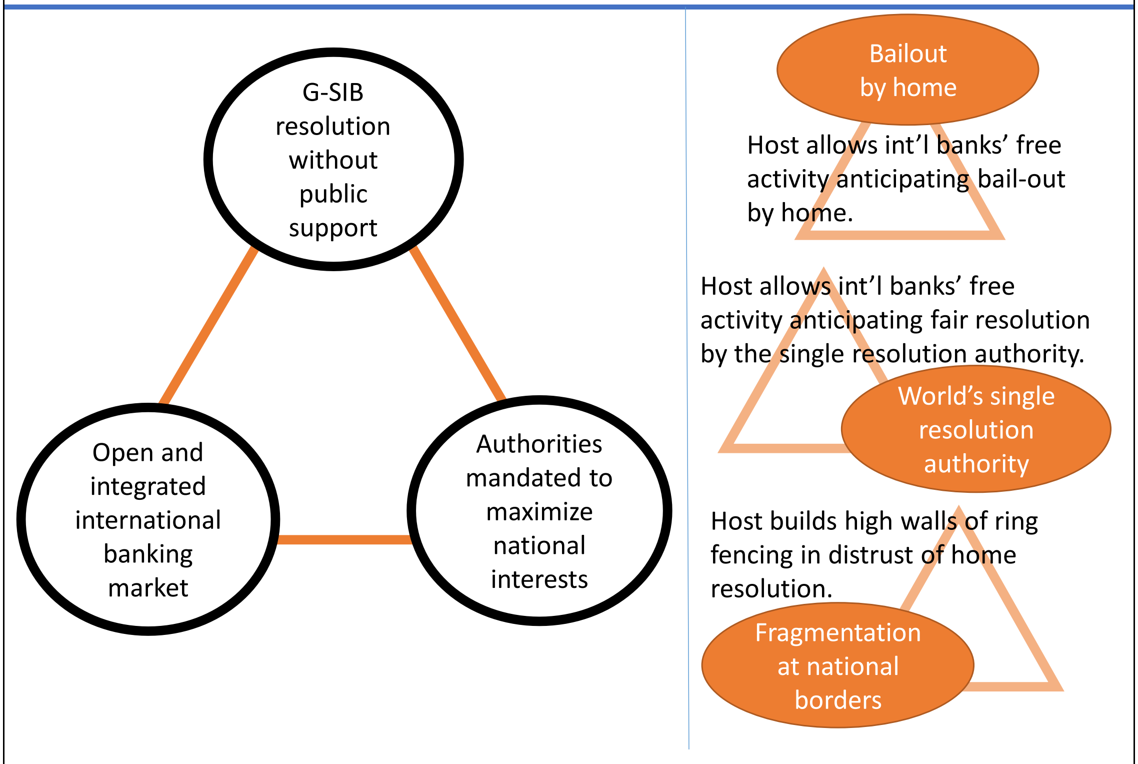
Then how can we avoid this Scenario 3? Preaching trust and cooperation between authorities alone would not be enough, as each national authority is legally and politically mandated to protect domestic interests.

Dirk Schoenmaker of the Erasmus University proposes the idea of financial trilemma between financial stability, international banking and national financial

[2] FSB (2016), *Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB")*, August 18

policies.[3] This gives a concise expression well fitted to the nature of difficulties we face in our daily supervisory and regulatory activities. We may be facing its one particular application: a trilemma, or an impossible trinity, between G-SIB resolution without public support, open and integrated international banking, and authorities mandated to maximize their national interests.

An impossible trinity and three (unsatisfactory) corner solutions



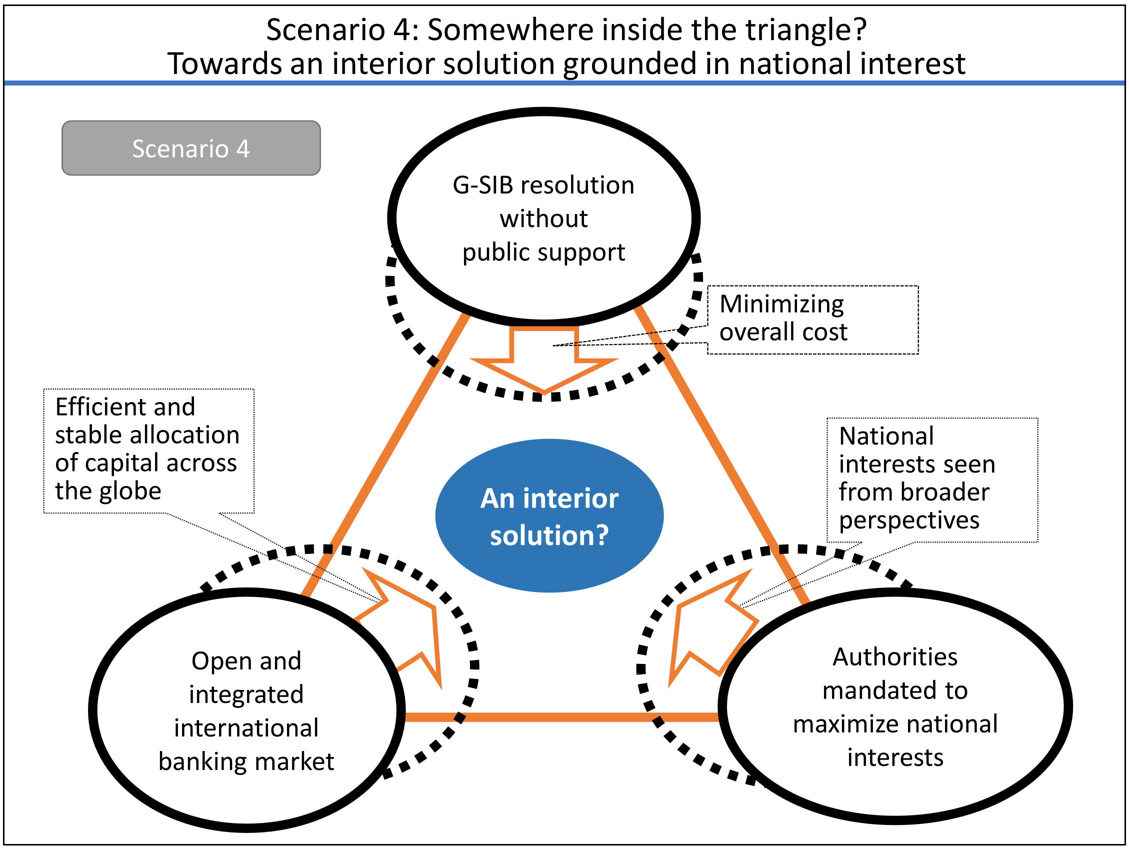
In pre-crisis days, there was an implicit assumption that home jurisdiction would take the whole responsibility even resorting to bail-out. But Lehman, the Icelandic banks and other cases undermined this assumption. With strong political sentiment for G-SIB resolution without public support in many jurisdictions, fully reverting back to the old days would no longer be an option.

If the world should have a single resolution authority, a single resolution fund, a single deposit insurance system and a single global democracy, we could surely avert Scenario 3, but it is not likely to happen either.

If the two goals -- G-SIB resolution without public support and authorities' domestic mandate -- cannot be compromised, the only natural solution would be sacrificing fully integrated international banking, hence Scenario 3.

[3] Dirk Schoenmaker (2013), *Governance of International Banking: The Financial Trilemma*, Oxford University Press

How can we overcome this trilemma?



I do not have an answer, but let me try sketching out an alternative scenario, Scenario 4, in which we explore a solution somewhere inside the triangle. The proposal here is to clarify and re-define the three goals to be able to make an informed judgement about tradeoffs and be somewhat more flexible, so that we will not be forced to forgo one of the three goals. The interior solution may not fully satisfy the original three goals, but may maximize the overall welfare.

Let me start with the first of the three goals: G-SIB resolution without public support. This goal is about balancing the need to contain moral hazard and ex ante build up of risk and the need for orderly resolution and minimizing the ex post cost of crisis. In assessing the latter need, we may want to take it into consideration that the public is exposed to various risks, including the risk of losing jobs, reduced value of assets in their pension program, and loss in tax revenue as consequences of a financial crisis. In addition, in many cases, public support is fully repaid by the resolved institutions in their recovery processes. There may be room to redefine the first goal as the minimization of the overall cost to the national economy while controlling moral hazard, instead of categorical denial of public support.

Second, though we need an open and integrated international banking market, we should accept the need to enhance host authorities' confidence by ensuring adequate resources in local operations.

In addition, we do not necessarily want an environment for unfettered money game. We want a system in which resources are efficiently allocated across the globe, while mitigating shocks, containing negative spillovers and ensuring domestic and global financial resilience.

We might want to explore which form of cross-border capital flow will be suited to attain this objective, comparing capital flow through direct cross-border lending, through bank branches, through bank subsidiaries, and through capital markets. Excessive restrictions on local branches and subsidiaries of foreign financial institutions might cause over-reliance on direct cross-border lending and funding through capital market and unintentionally destabilize the capital flows.

Lastly, pursut of national interests may become more compatible with the other two goals if they are seen from broader perspectives.

National interests seen from broader perspectives

Balancing the interest as a host authority and a home authority

- Interest as host
  - ✓ protecting interests of local creditors and depositors
  - ✓ reducing the risk of spillover from disorderly group resolution
- Interest as home
  - ✓ orderly group resolution, more resource in home
  - ✓ stronger host confidence to avoid excessive prepositioning and premature ring-fencing by hosts

Balancing a bank's good global life and good national death

- A bank's good global life
  - ✓ open and integrated international banking market => efficient global capital allocation
  - ✓ sound and sustainable international banking
- A bank's good national death
  - ✓ minimizing moral hazard
  - ✓ ensuring crisis management capability
  - ✓ minimizing immediate costs to taxpayers
  - ✓ minimizing the ultimate costs to the national economy

For example, a country can be a host to foreign banks and the home to its own banks at the same time. The country might want to balance their interests as a host with those as a home.

By focusing only on the immediate interests as a host, the country may spread high walls around the globe and damage its interests as a home.

The interests as a host are not limited to protecting the interests of local creditors and depositors but should include reducing the risk of negative spillovers from disorderly resolutions abroad.

The interests as a home should not be limited to securing orderly group resolution by pooling as much resources in the center. It should also include building stronger host confidence to prevent excessive pre-positioning and premature ring-fencing by hosts.

Another balance to strike is between the good life and the good death of banks. Even if we accept Mervyn King's dictum that banks are global in life and national in death, a good life is as important as a good death. We should balance a bank's good global life and its good national death.

A bank's good global life will need an open and integrated international banking market, but it should take the form of sound and sustainable international banking.

A bank's good national death would require both the minimization of moral hazard and reliable crisis management capability. We need to minimize the ultimate costs to the national economy, while minimizing immediate cost to taxpayers.

Governmental agencies tend to focus on only one or two of the multiple elements or dimensions of national interests described above, and tend to focus more on the immediate consequences than on the total outcome. We need to consider how to overcome such bureaucratic myopia.

Let me recap my propositions:

- First, we might want to be vigilant to the scenario of greater fragmentation of the international banking market, even if the current level of fragmentation may appear to be within an acceptable range.

- Second, preaching trust and cooperation alone may not be enough.

- Third, it may be impossible to achieve all of the following three goals at the same time; resolution without public support, authorities maximizing national interests and open and integrated international banking.

- Fourth, any corner solutions satisfying two and sacrificing one would not work. We may want to explore an interior solution.

- Fifth, the first step of the exploration may be to accurately understand the multiple dimensions and elements of national interests from broader perspectives.

This morning, in his opening remarks,[4] FSB chair Randal Quarles argued for a careful configuration that recognizes mutual and separate interests. I fully agree with him. I hope regulators, resolution authorities, industry and academia could explore together how to do it going forward.

Thank you.

[4] Randal K. Quarles (2019), Government of Union: Achieving Certainty in Cross-Border Finance, September 26