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# Bank regulation and foreign-owned banks

George G. Kaufman, Loyola University Chicago

This article is a revised version of the paper presented by Professor George Kaufman in Wellington, New Zealand, on 7 April this year, when he was Professorial Fellow in Monetary and Financial Economics at Victoria University, on a programme sponsored by the Reserve Bank of New Zealand.\*

The American novelist F. Scott Fitzgerald started one of his books by noting that the rich “are different”; and there is a widespread perception that banks are also different from other firms, and that bank failures are different from the failure of other firms, particularly failures of large, systemic banks. There would probably be far fewer in the audience tonight if this lecture had been on grocery stores or steel mills. Banks have long been treated differently with respect to public policy. In the United States, banks need to obtain special charters from the states, and may be chartered by the federal government, an advantage that is not available to most other firms. In New Zealand, banks must be registered by the Reserve Bank to use the word “bank” in their name. In the United States, bank insolvencies are resolved under a special bank code by the bank regulators rather than under the general bankruptcy code by the bankruptcy courts. To a large extent, this is because bank failures are widely perceived to be more damaging to the customers of the affected banks, both depositors and borrowers, than the failure of like-sized other firms and more likely to spill over to other banks through knock-on (contagion, cascade or domino) effects, the payments system, the financial system as a whole, and even beyond to the wider economy.

But beyond the direct damage, bank failures are widely perceived to be more frightening than the failure of other firms. This may result in indirect, collateral damage. “Horror” books and movies based on bank failures are not uncommon, while few such books or movies are based on the failure of grocery stores or steel mills. Bank failures are perceived as being more frightening for a number of reasons:

- Banks deal in intangibles, which cannot be seen. This makes it more difficult for many to understand their operations than, say, operation of grocery stores or steel mills; and causes banks to be shrouded in mystery and uncertainty.
- Almost everyone has contact with banks in their daily life as either or both a depositor and/or borrower.
- Bank deposits make up a large percentage of the national money supply.
- Bank deposits frequently represent the owners’ principal and most liquid assets.
- Banks operate the payments system.
- Bank assets can be moved very quickly.
- Bank assets are very large in the economy.
- Banks operate internationally.
- Banks operate in highly sophisticated and complex markets, such as derivatives markets, which are both very large and very volatile.

Breakdowns in these areas are highly disruptive. Indeed, failed banks are sometimes closed physically as well as legally so that depositors cannot access their accounts and borrowers their credit lines, and payments in process are not completed, leading to defaults. Whether or not the great public fear of bank failures is rational or justified, it exists; and perception is often as important as reality and requires recognition in the formation of public policy.

Researchers at the World Bank have identified nearly 120 systemic bank crises in 93 countries since the mid-1970s - some countries suffered more than one crisis - and another 50 or so near-crises in 45 countries.<sup>1</sup> Thus, more than one half of all countries in nearly all parts of the world have

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1 World Bank, 2001, p75

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experienced serious banking crises in recent memory. Many of the countries that did not suffer such crises are emerging economies that do not have a functioning banking system.

The costs of these crises have been high. Bank crises are often associated with recessions in the macroeconomy, although they are more frequently the result rather than the cause of the economic downturns. Nevertheless, bank failures exacerbate economic downturns. A survey by the International Monetary Fund that examined 54 banking crises between 1975 and 1997 reported that GDP during the crises averaged nearly 12 per cent below trend output and that it took these countries, on average, three years to recover.<sup>2</sup>

In addition, almost all countries did not impose the full cost of bank failures on the creditors and shareholders of the banks - the parties that would normally bear much of the cost of other business firm failures - but partially or totally protected these parties, particularly the banks' depositors, against loss. Instead, some of the loss was shifted to taxpayers and, because insolvent banks were frequently permitted to operate for long periods of time after they became insolvent and increase their losses further, in many cases these wealth transfer costs were very high. As a per cent of GDP, transfer costs from depositors to taxpayers are estimated to be greater than 50 per cent in Argentina in the early 1980s - Argentina has suffered three banking crises since the 1970s - and between 30 and 50 per cent in Thailand, South Korea, Chile, and Uruguay, among others. Resolution of the New Zealand bank insolvencies of the late 1980s is estimated to have cost taxpayers about 2 per cent of GDP - about the same as the US savings and loan failures of the 1980s and one half of the cost of Australian failures in the same period.<sup>3</sup>

A large share of the high social cost of bank failures arises from poor and inefficient means of resolving insolvent banks. As noted above, the resolutions are frequently delayed until long after the banks become insolvent and the costs are often not fully imposed on the banks' creditors

or owners. Good public policy demands that these societal costs can and should be reduced and largely removed from the shoulders of taxpayers.

In this paper, I propose a general four point or step program for efficient and low short-term and long-term cost resolution of large insolvent banks. I propose such a program not because I am predicting that any New Zealand banks are likely to fail, but because history has shown that banks do fail in all countries at some time and that the costs of such insolvencies can be reduced if a country plans ahead of time on how to respond if and when this does occur. I note both short-term and long-term costs because many of the poor resolution practices have resulted from attempts to keep immediate costs low without great concern for later costs. The program proposed is based on my analysis of actual bank resolutions throughout history, but particularly in the United States, as well as economic and finance theory. The program is general, but can and should be tweaked and tailored to the institutional particulars of different countries and I will make some comments on how near the end of the paper.<sup>4</sup>

One of these particulars is the importance of foreign-owned banks, where New Zealand ranks number one in the world with some 99 per cent of its bank assets in foreign-owned banks. My analysis is based heavily on US experience, not only because I am most familiar with it, but because the United States has many banks - some 8,000 currently, and about 30,000 in the 1920s - has good historical data on these banks dating back to the Civil War of the 1860s and even before, and effectively has had no state-owned banks, which muddy the waters. Unfortunately, unlike the case in New Zealand, foreign bank ownership in the United States is relatively unimportant, accounting for only 5 per cent of total bank assets. This introduces additional problems that I will turn to in the final section of the paper. International banking may be said to be domestic banking made difficult.

I offer this program as much to stimulate thought and discussion as anything else. The program centres on:

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2 International Monetary Fund, 1998, p79

3 World Bank, 2001, p83 and Barth et al., 2004, p77. More recently, a study by the Basel Committee on Banking Supervision surveyed bank failures and resolution costs in eight industrial countries (2004).

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4 A number of more or less similar plans have been developed by others, eg, Mayes, 2004 and Mayes and Liuksila, 2004.

- Prompt recognition of economic insolvency and legal “closure” of insolvent banks according to a disclosed explicit “closure rule”.
- Prompt estimates of recovery values and corresponding losses or “haircuts” to be imposed on the banks’ depositors and other creditors.
- Prompt reopening of the bank under temporary government agency control – eg a bridge bank, with a full guarantee of existing deposits at the haircutted or protected amounts.
- Prompt reprivatization through recapitalization at adequate capital levels or liquidation.

Let me expand on these principles. To achieve them requires a number of things.

Prompt legal closure implies terminating the interests of existing shareholders, who knowingly assumed both the returns and risks associated with ownership. One should not privatize profits and socialize losses. At the same time, senior management should generally be changed. The rules for legal closure should be thoughtfully designed to maximize efficiency and minimize losses and be publicly disclosed fully, so that all players know the rules of the game. Evidence ranging from organizational management to child rearing clearly indicates that players play both better and more predictably in a world of certainty than in a world of uncertainty. The United States has recently introduced clearly specified rules for prompt corrective action (PCA) by regulators on financially troubled banks, including a clear legal closure rule when a bank’s equity declines to 2 per cent of its assets and instructions to regulators to resolve the bank at least long-run cost to the insurance fund. (The United States has limited explicit deposit insurance.) Such a closure rule permits the desirable exit of inefficient or unlucky banks at minimum societal cost.

Regulators in the United States also have authority to resolve banks for cause before this minimum closure requirement is hit. So that the closure rule is not breached without sufficient warning, and to attempt to prevent a troubled bank from deteriorating further down to the closure trigger, PCA imposes a number of other triggers, generally calibrated

in terms of capital ratios, at which time the regulators first may, and then must, impose sanctions to increase the cost of poor performance to the banks. The sanctions are modeled after those that the market imposes on troubled firms in non-regulated industries, such as reductions in dividends, restrictions on acquisitions and growth, a recapitalization plan, and changes in senior management. That is, the regulatory environment is made to mimic or simulate a market environment.

Prompt estimates of recovery values and depositor loss-sharing haircuts require current and accurate information on a troubled bank before its insolvency. This likely requires some on-site examination of these institutions to verify the accuracy of the publicly reported information and to obtain interim information. It is well known that, as a bank approaches insolvency, its reported financial statements approach fiction more than fact. Current and accurate information is also required by the regulators if they are to market the bank quickly upon declaration of insolvency.

The magnitude of depositor haircuts depends, among other things, both on the promptness of legal closure and on public policy. The quicker a bank is resolved upon declining to the specified closure-rule trigger, the smaller are the losses and therefore also the smaller the depositor haircuts are likely to be. If a bank or any other firm is resolved before its true capital (net worth) position turns negative, the only loss is to its shareholders. Depositors and other creditors are fully protected. In addition, as noted, the longer an insolvent firm is not legally closed and permitted to continue to operate, the more likely is it to continue to generate operating losses and to increase its risk exposure in the process of “gambling for resurrection.”

Public policy may at times wish partially or fully to protect two groups of depositors against loss:

- Small depositors, primarily for political reasons. They are likely to lobby the government for protection loudly and in large numbers. But it also may be economically efficient to provide them with a low-cost, riskless depository and to avoid the relatively high cost of having them collect and process information to monitor and discipline banks in order to protect their reasonably

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small accounts. Lastly, small depositors are the only ones who can operate on currency and are thus able to run on the banking system as a whole, exchanging deposits for currency and, in the absence of central bank intervention, decreasing the money supply by a larger amount, as described in basic money and banking textbooks.

- Large depositors, if and only if there is a serious threat to financial stability by imposing full pro rata losses on them. This is the so-called “too big to fail” or TBTF policy. But TBTF is often abused at very high societal cost.<sup>5</sup> In addition, in the United States, TBTF really never meant what it said. With effectively only 1.5 exceptions among a reasonably large number, all big insolvent banks in the United States were failed legally and placed in receivership. Shareholders’ interests were terminated. (The Continental Illinois National Bank in my home town of Chicago, whose resolution in 1984 gave rise to the term TBTF, is the 1/2 exception, as its private shareholders’ interests were terminated but not until five years later.) TBTF actually referred to protection for de jure uninsured depositors and other creditors. (In the United States, the first \$100,000 of deposits is explicitly insured by the FDIC, a government agency funded by the insured banks.)

De facto protection of de jure uninsured depositors at some large banks in the 1980s eventually became so costly that it threatened to bankrupt the FDIC and was perceived to be so unfairly applied across banks that it became politically unpopular. In addition, it became evident that protecting these depositors removed an important source of discipline on the banks and increased the likelihood of future losses. Nor is there sound evidence that imposing losses on large depositors necessarily leads to losses elsewhere or widespread financial instability. In response, reform legislation enacted in 1991, known as the FDIC Improvement Act, or FDICIA, prohibited the FDIC from protecting uninsured depositors and creditors in a bank resolution. But there was an exception. The FDIC could protect these claimants if not protecting them threatened aggregate financial instability

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<sup>5</sup> Kaufman, 2004. See also Stern and Feldman, 2004

and protecting them would mitigate this threat. TBTF was transformed into the systemic risk exemption (or SRE).

However, invoking SRE is not easy. Five high barriers – three ex ante and two ex post – must be cleared and a paper trail created and maintained.<sup>6</sup> The ex ante barriers are:

- A recommendation to the Secretary of the Treasury to invoke SRE approved in writing by two thirds of the board of directors of the FDIC and two thirds of the Board of Governors of the Federal Reserve System.
- Approval by the Secretary of the Treasury in writing after consultation with the President of the United States.
- Written notification of approval by the Secretary to the Chairs of the House and Senate Banking Committees.

If approved and invoked, two ex post barriers exist that are likely to affect the decision whether to invoke SRE:

- An audit must be conducted by the congressional General Accounting Office (GAO) of the reasons for invoking SRE and the effectiveness of the actions taken.
- Any resulting loss to the FDIC from protecting uninsured claimants must be paid expeditiously by a special assessment on all other banks.

These are high barriers to hurdle. Combined with the required paper trail, this framework is likely to encourage accountability and discourage hasty, unthoughtful action. To date, SRE has not been invoked in the United States. But there has not been a fair test. No really large, money centre bank has encountered serious financial difficulties. Nevertheless, uninsured depositors at all other failed banks have shared in any losses with the FDIC.

To make this program effective in minimizing the short and long-term societal cost of resolving insolvent large banks, the plan must be fully developed, be in place “on the shelf” for immediate use, and be fully and widely disclosed to the public. If it is not, political pressures at the moment of crisis will overcome any ability of policy-makers to stand back and develop a program. As a result, all or nearly all potentially damaged parties are likely to be protected. Federal Reserve

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<sup>6</sup> Kaufman, 2004

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Chairman Alan Greenspan has recently noted this in testifying before the US Congress on resolving large US government sponsored entities (GSEs), such as Fannie Mae and Freddie Mac, which are privately owned mortgage lenders with past government ownership (and which have retained a close association with the government in the eyes of many investors). Greenspan testified that it was important to:

“...clarify the circumstances under which [the GSEs]... can become insolvent.... This process must be clear before it is needed; otherwise the hands of any regulator would be constrained by uncertainties... Left unresolved, such uncertainties would only heighten the prospect that a crisis would result in explicit guaranteeing.”<sup>7</sup>

It is important that banks of any substantial size are not physically closed for any extended length of time after they are legally closed. Among other things, physical closure implies that existing borrowers lose their credit lines and cannot extend maturing loans and existing depositors or other creditors, including other banks, may not have full and immediate access to even the haircutted value of their accounts and other claims at maturity, including those payment instruments in the process of clearing. Most deposits are effectively frozen, frequently until proceeds are obtained from the sale or liquidation of the bank, which could be a lengthy process. Demand or current accounts are involuntarily transformed into time accounts. Fear of account freezing in bank failures is often as great if not greater in many countries as fear of reduced value of accounts due to credit losses. Indeed, important firms in most other key industries are not physically closed when they fail. For example, major bankrupt airlines typically keep flying for some time and electric power companies keep generating electricity. To keep banks open and operating during the reprivatization process, the regulators need to arrange for advancing the expected proceeds from the pending reprivatization to the depositors. In the United States, the FDIC has the authority to advance dividends to uninsured depositors almost immediately, based on a conservative estimate of the pro rata recovery value. Insured depositors are also advanced funds, so that they have access

to the par value of their accounts the next business day or so (Kaufman and Seelig, 2002).

If the plan is widely and fully known, bankers and the public will modify their behavior and regulators can act with greater confidence. The “tougher” and clearer the insolvency rules, the greater also will be market discipline on misbehaving bank management by bank shareholders.

Let me now turn to a few remarks on how the institutional arrangements in New Zealand affect or are affected by this program. First, to deposit insurance. New Zealand prides itself on not having an explicit deposit insurance program and thus not being required to protect any depositor or other claimant at insolvent banks. But there is a long distance between not being required to provide deposit insurance and not effectively providing deposit insurance. The Reserve Bank of New Zealand Act provides the Bank with the authority to act as a lender of last resort if it “considers it necessary for the purpose of maintaining the soundness of the financial system”.

Although the purpose of any intervention may not be to protect depositors, this language is sufficiently vague to permit such an interpretation. In 2000, then Deputy Prime Minister Jim Anderton stated “It’s inconceivable that banks can be allowed to fail with all the repercussions that would go through the whole community.”<sup>8</sup> And in recent memory, the government has protected some depositors at insolvent institutions. Despite an immediate rebuttal by the Reserve Bank Deputy Governor that “Depositors and other creditors of banks should operate on the presumption that, if a bank were to fail the government would not insulate them from losses,” such statements from government officials serve to fuel doubts.<sup>9</sup>

The Reserve Bank’s website also notes that while “the RBNZ would generally recommend against any form of taxpayer-funded rescue ... the ultimate decision ... would be made by the government of the day.” This strengthens the government statement and significantly weakens any no de facto deposit insurance claim. Indeed, recent surveys suggest that a substantial percentage of the New Zealand

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7 Greenspan, 2004, p6.

8 “For the record,” p69

9 Ibid.

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population believes that depositors would be protected in bank failures. If so, the regulators' credibility is at stake and, in the area of prudential regulation, as in monetary policy, credibility is the most important weapon that regulators have. Unless a significant percentage of depositors truly perceive themselves at risk, emphasis on public disclosure is less effective. Disclosure is a necessary but not sufficient condition for market discipline to be effective. If few if any depositors or other bank creditors perceive themselves at risk, information disclosed is less likely to be processed and used to discipline banks. So what do I recommend?

As much as I favour not protecting large depositors, I favour explicitly protecting small depositors in the form of full deposit insurance for the first x dollars of deposits.<sup>10</sup> From a practical point of view, it is difficult to avoid such protection at the time of resolution.<sup>11</sup> By reducing pressure from small depositors, it is easier to leave large depositors, who both can monitor their bank's financials and are accustomed to taking risks in their short-term investments, such as commercial paper, unprotected. Thus, on balance, pressure on banks to restrain risk-taking moral hazard behavior is not necessarily reduced. Studies by the World Bank show that the costs of bank failures are on average lower in industrial countries that have explicit deposit insurance and strong and credible institutions, property rights, legal systems, and regulatory independence.<sup>12</sup> New Zealand clearly has the latter group of characteristics. How the insurance is to be provided and who pays for it needs to be determined, but considerable evidence exists evaluating alternative structures.

To enhance credibility for keeping uninsured deposits uninsured, I would recommend imposing explicit high

barriers for invoking exemptions, such as for SRE in the United States. Of course, they need to be tailored to the institutional structure of New Zealand, but could involve written sign-offs by the Reserve Bank, Minister of Finance and Prime Minister that protecting uninsured depositors is necessary to maintain financial stability. This arrangement should be viewed as part of the package of providing explicit insurance for small depositors. Both need to be adopted together. Who pays the cost of any assistance that may be provided to uninsured depositors should also be clearly specified. Should it be the other banks or taxpayers? I would prefer the other banks, as this is likely to create additional pressure not to provide the assistance. To further minimize the pressure on the government to provide support, Professor John Singleton of Victoria University has proposed having the government delegate the authority for resolution to the Reserve Bank for a specified length of time similar to the delegation it now makes to the Reserve Bank on achieving the agreed-upon inflation target (Reserve Bank, 2002 and 2003).

I would also recommend that New Zealand add both a simple capital leverage ratio (equity or total capital to total assets) to the Basel-type risk-based capital measure requirements that it now imposes on banks and a fuller version of the PCA that includes a number of explicit triggers for intervention by the Reserve Bank on a progressively harsher and more mandatory basis. While the market evaluates a bank's risk exposure in determining the appropriate amount of capital required, the Basel measures assume that the regulator-determined weights are the same as the market-determined weights. Evidence suggests they are not and encourages game playing by the banks to reduce their risk-weighted assets. The leverage ratio reduces such gaming and puts banks on the same basis as all other firms for comparison. For example, most other firms have a worldwide average capital to total asset ratios of nearly 50 per cent, implying leverage ratios of 2 to 3, rather than non-risk adjusted capital ratios of 6 to 8 per cent, with leverage ratios of 12 to 16 that better capitalized banks in developed economies maintain.<sup>13</sup> By encouraging earlier regulatory intervention before insolvency, multiple action triggers would both improve the

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10 Alternatively this can be achieved by imposing haircuts only after the first \$x of deposits. This idea was proposed to me in discussions at the Reserve Bank.

11 The appeal of avoiding political problems with small creditors is reflected in a recent proposal to creditors by Origin Pacific, the second largest airline in New Zealand, to avoid bankruptcy by paying all creditors owed less than NZ\$10,000 in full but paying only 40 cents on the dollar over the next five years to all other larger creditors. The current shareholders would then recapitalize the firm. The company also blamed part of its problems on "the government bailout of Air New Zealand in 2001." (Van den Bergh, 2004, p. 1.)

12 World Bank, 2001. However, the analysis may not have included observations for countries that had no explicit insurance but favourable institutions. I am indebted to Ian Harrison at the Reserve Bank for this observation. See also Kane and Klingebiel, 2004 (Forthcoming).

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13 World Bank, 2001, p.50

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probability of regulators being able to turn troubled banks around before failure and reduce the probability of delayed or weak action by the regulators.

Although some of my suggestions would increase regulation and supervision, and appear to run contrary to both my preferences and the well-known preferences of the Reserve Bank of New Zealand and government for self and market discipline, rather than intrusive government regulation and supervision, I do not believe that they would be unduly intrusive on well-operated banks. It would only be when a bank stops being well operated and becomes troubled that the intrusiveness factor kicks in. Indeed, this is a carrot and stick structure that may be viewed as reinforcing the incentives for banks to avoid getting themselves into such unfortunate positions, and would basically formalize the informal monitoring and consultation that occurs now. If I had the time, I would also discuss a plan to enhance market discipline by requiring banks to issue subordinated debt, a proposal that is receiving attention in some countries (Shadow, 2000). This may be particularly useful for gauging the financial condition of wholly-owned subsidiary banks, which represent a relatively small part of the parent's operations so that information based on the parent's stock or debt prices may not be very informative about the subsidiaries. This may be particularly helpful to regulators in a country in which relatively small subsidiaries of a parent bank in another country are located. But that is for another day.

Lastly, I will briefly comment on some unique issues raised by the high degree of foreign ownership of banks in New Zealand. As I noted earlier, some 99 per cent of registered banks' assets are foreign owned and 85 per cent are in the largest five banks that are all owned by Australian banks.<sup>14</sup> (The next largest percentage of foreign bank ownership is in Botswana, with 97 per cent, followed by Luxembourg with 95 per cent.)

Much has recently been written about the benefits of foreign bank entry, but less about the costs, and almost all with respect to emerging rather than developed economies.<sup>15</sup> The two primary areas of concern are economic efficiency

and safety. I will touch mostly on the safety issues. There is little doubt that foreign bank entry enhances competition and efficiency, holding other things equal, in both developed and developing countries, and New Zealand appears to have benefited from the entry of major foreign banks.<sup>16</sup> But the safety issue is more complex, particularly with respect to the resolution of insolvencies.

It is obvious that the legal and regulatory structures of the foreign bank's home country as well as those of the host country matter. At minimum, this increases complexity, as it requires knowledge of foreign institutional structures by host countries, particularly with respect to insolvency resolutions, and the more foreign countries represented, the more complex.<sup>17</sup> But is also likely to be more difficult than this, as the legal and regulatory structures may conflict, particularly in times of stress. The banks are then subject to two or more masters!<sup>18</sup> A major issue is the form of organization of the foreign facility - branch or subsidiary. Here safety and efficiency may conflict and trade-offs between the two exist. A branch is likely to be somewhat more efficient and lower cost for the banking organization, as it is not a separate legal entity and is operated on a fully consolidated and integrated basis. Its financial health is also likely to be dependent primarily on the health of the home office and thus on the state of the economy in the home country.<sup>19</sup> Although branches may be safer than either a subsidiary or independent bank of equal size, as the latter's share of assets in the overall bank are likely to be more diversified, branches are more difficult for the host regulators to monitor and discipline. Host country regulators are thus likely to rely heavily on the home countries' regulators for monitoring

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<sup>16</sup> Hull, 2002 and Barth et al., 2004

<sup>17</sup> For an expansion on this point, see Herring, 2003.

<sup>18</sup> For example, with respect to implementing Basel II capital requirements, New Zealand plans to apply the standardised approach for all banks; Australia expects the large banks will implement either of the internal ratings approaches and the others the standardized approach, and the United States will require the advanced internal ratings approach for the 10 or so largest, internationally active banks. Other U S banks may choose this approach or will apply the Basel I requirements. A similar analysis for European Union and , in particular Nordic, countries appears in Denmark, 2004.

<sup>19</sup> Peek and Rosengren (2000a) report that domestic problems at Japanese banks in the early 1990s led to sharp reductions in commercial real estate lending at their U S branches. In an earlier study (1997), they report that business lending was cut back more sharply at Japanese branches in the U S than at U S subsidiaries of Japanese banks.

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<sup>14</sup> Barth et al., 2004

<sup>15</sup> Peek and Rosengren, 2000

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and disciplining. This likely requires some agreement on information sharing on a timely basis and cooperation on some prudential actions. A subsidiary is, at least in theory, separate from its parent and stands on its own feet with its own capital. It is subject to the same capital standards and the same insolvency resolution process as the host regulator applies to domestic banks. Its financial health should reflect primarily the health of the host country.<sup>20</sup>

Foreign branches introduce another problem for the host country if the home country has depositor preference legislation that gives priority to deposits at domestic over foreign offices of failed banks. Such legislation is currently in effect both in the United States and, more importantly for New Zealand, in Australia. To depositors in these home countries, deposits in branches in foreign countries provide an additional layer of protection above a bank's capital. Moreover, home regulators may be incentivized to resolve home banks less quickly, as any additional losses would be borne first by depositors in other countries. To protect against this, the Reserve Bank is exploring how domestic deposits at large branches of foreign banks could be matched or effectively collateralized by domestic assets. Indeed, this is the predictable dynamic response to depositor preference provisions (Kaufman, 1997). In case of danger, low priority claimants will attempt to increase their priority by securitizing or running. Until such an arrangement is in place, New Zealand depositors at branches of Australian and US banks in New Zealand appear to assume greater risk than depositors at these banks in home offices and should receive a correspondingly higher interest rate.

On the other hand, it may be argued that regulators in some home countries may support their insolvent large, systemic banks through liquidity or other assistance, so that the host depositors are protected via spill-over. But one may wonder whether the home country's taxpayers may not be even more reluctant to bail-out depositors in foreign countries than in their own. Likewise, it is sometimes argued that parent holding companies in home countries are likely to recapitalize their sick subsidiaries in other countries in order

to avoid reputational damage. Thus, host country regulators need not be greatly concerned and rely on their home country counterparts. However, the decision whether to support or not is likely to involve a careful weighing by the holding company of the costs of such recapitalization versus the potential reputational harm of walking away from the subsidiary. This is likely to be done on a case-by-case basis rather than by a general, once-and-for-all rule.

A subsidiary may also be somewhat weaker than it appears. Although fund transfers to the parent are restricted, once done, it might be difficult to reclaim the assets from another country and legal jurisdiction even though they might have been transferred illegally, say, in anticipation of insolvency. In addition, any financial difficulties experienced by the parent bank may have adverse reputational spill-over to the subsidiary. Adverse reputational spill-over effects may be more important for subsidiaries in relatively small countries as large country suppliers of funds may view the country as being too minor to expend significant resources on differentiating between the foreign parent and the domestic subsidiary and even among domestic subsidiaries of different parents.

Perhaps most important is the issue of functionality for either a subsidiary or branch. Most banking organizations, whether they involve branch or holding company subsidiaries, are managed on a centralized and integrated basis. Major decision-makers, technical personnel, records and computer and telecommunications facilities are physically located at the home office or tightly under the control of the home office. From the point of view of the subsidiary, these services are effectively outsourced. Thus, without speedy access to these facilities, it may not be easy for the regulators to continue to operate a solvent subsidiary office of an insolvent foreign parent as a stand-alone facility without any or, at most, minor interruption, or to resolve an insolvent subsidiary and either maintain it in operation or liquidate it, as discussed earlier. A branch would be even more difficult to operate. Obtaining full and speedy access to the necessary facilities is difficult, even if all the bank operations are in the same country and under the same legislative, regulatory and judicial regimes. But it is far more difficult if the subsidiary or branch is in a different country than the parent or home office, where the

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20 Hull (2002) attempts to quantify the importance of shocks in New Zealand and Australia on banks, branches, and subsidiaries

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necessary management and facilities are likely to be housed, and under different legislative, regulatory, and judicial regimes.

How then, for example, do host country regulators provide for assured immediate transfer from the home or possibly even third country? I suspect no country is more aware of these problems than is New Zealand.<sup>21</sup> Although no easy solution is evident, agreements to house some facilities that are nowadays required for redundancy purposes in the host country or where host regulators have immediate and guaranteed legal access appear doable and appropriate.

I would also wonder whether having 85 per cent of bank assets in banks owned by banks in only one other country that is considerably larger may not open the host country both to excessive potential spill-over effects from problems in that country and excessive political leverage that could impinge on the host country's regulatory independence and induce it to defer to the home country regulators more than otherwise. At the same time, the host country is tempted to rely even more on the competency of that country's regulators to maintain the financial health of the banking organizations headquartered there.<sup>22</sup>

It is obvious that I have only scratched the surface of these last issues. In part, this reflects the fact that I come from a country in which these issues are not as pressing and thus not as much analyzed. The issues are complex and require greater quantification. Greater certainty regarding the rules of the game would benefit all participants over the long run - bankers, regulators and the taxpayers. I am happy to note that these issues have received, and are continuing to receive, serious attention at the Reserve Bank. The Bank, for example, is in the process of developing a strategy for resolving bank insolvencies, that it refers to as "bank creditor recapitalization" (or BCR) that includes many of the features that I spelled out in my four-point program above. The Bank is also involved in exploring ways of improving its ability to resolve foreign branch insolvencies as well as subsidiaries and to obtain the necessary functionality facilities. I hope

that my thoughts expressed here will be of help to the Bank in perfecting these strategies. Some of the ideas may require some re-thinking of long-held views, but my reading based on the few weeks that I visited is that New Zealand does not shy away from bold ideas or measures.

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<sup>22</sup> New Zealand and Australia have recently announced their intentions to explore a closer integration of banking regulation, Reserve Bank, 2004.

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