

Nov 14, 2005

From Subsidiary to Branch Organization of International Banks: New Challenges and Opportunities for Regulators*

Lawrence G. Goldberg⁺
University of Miami

Richard J. Sweeney
Georgetown University

Clas Wihlborg
Copenhagen Business School and
University of California, Riverside

In Memory of Larry Goldberg, Dear Friend and Colleague

Abstract: Nordea is the first major international bank planning to operate important host country activities in branches as the Second European banking directive envisions rather than as subsidiaries. Nordea is the result of mergers of roughly equal-size universal banks in four Nordic countries with the intention to reap economies of scale and scope by providing services in an integrated organization. Nordea has so far operated under a legal structure with subsidiaries in the host countries. When the new branch organization is implemented, EU directives specify that the home country is responsible for supervision, regulation as well as deposit insurance. Supervisors in all involved countries are challenged by this prospect and they are negotiating to obtain an acceptable division of responsibilities. We argue that the Nordea case offers an opportunity to implement the EU's vision and to develop institutional foundations for substantial market discipline in banking. In particular, distress resolution and insolvency procedures for banks must be made rule based and credible for host country authorities to accept home country control.

* A preliminary version of this paper was presented at conference on "Integrated Cross-Border Banking: Issues in Implementation, Regulation and Supervision" organized by the Center for Law, Economics and Financial Institutions at CBS (LEFIC) on Oct. 29, 2004.

⁺ Deceased, March 11 2005

From Subsidiary to Branch Organization of International Banks: New Challenges and Opportunities for Regulators

Nordea is the first major international bank planning to operate important host country activities in branches, as the Second European banking directive envisions, rather than as subsidiaries. Nordea is the result of mergers of roughly equal-size universal banks in four Nordic countries with the intention to reap economies of scale and scope by providing services in an integrated organization. Nordea has so far operated under a legal structure with subsidiaries in the host countries. When the new branch organization is implemented, EU directives specify that the home country is responsible for supervision and regulation as well as deposit insurance. Supervisors in all involved countries are challenged by this prospect and they are negotiating to obtain an acceptable division of responsibilities. We argue that the Nordea case offers an opportunity to implement the EU's vision and to develop institutional foundations for substantial market discipline in banking. In particular, distress resolution and insolvency procedures for banks must be made rule based and credible for host country authorities to accept home country control.

From Subsidiary to Branch Organization of International Banks: New Challenges and Opportunities for Regulators

I. Introduction

Bank mergers across borders have accelerated in recent years. Despite the relaxation of restrictions on mergers in Europe with the passage of the European Union Banking Directives, the number of cross-border mergers has not approached the amount most observers expected. As the pace is picking up, important issues arise for regulators and supervisors in both home and host countries of international banks. In addition, important operational and structural questions arise for management of the combined companies. One aspect discussed in this paper concerns the choice between subsidiary and branch structures in host countries. Subsidiary structures dominate currently but the EU directives are based on the vision that cross-border banking can be conducted in branches under a single license, home country control and home country deposit insurance within the EU.

Operating across country lines leads to questions and concerns that do not appear when the bank is located only in one country and must follow the rules of that country only. Numerous banking problems have arisen for banks with offices outside their home country. As noted by Herring (2004), regulators have had a difficult time satisfactorily resolving these cases, which typically involve a number of subsidiaries. The challenges are likely to be different when a distressed bank is operating cross-border in branches.

This paper takes as its starting point a recent cross-border exercise that has confounded regulators and managers, the case of Nordea. Unlike most cross-border consolidations that involve a dominant bank assuming control over a smaller bank in another country, the Nordea case involves joint ownership from four closely linked and similar sized countries (Denmark, Finland, Norway, and Sweden). The original banks that merged into Nordea during the period 1997-2000 were all important in their countries with market shares ranging from 15 percent in Norway to 40 percent in Finland. In addition, non-banking activities such as insurance and asset management played important roles in the original banks and continue to do so in the successor bank.

An important aspect of Nordea's strategy is that it intends to serve all countries involved by means of an integrated organization for each product area, with the purpose of achieving economies of scale within functional areas and economies of scope across functional areas and products. In particular, the legal structure with subsidiaries in the four countries has not and does not coincide with the internal organization across countries and functions. As a result, the four countries' supervisors have had to develop new approaches to adjust supervision to the business organization rather than the legal organization of the bank.

As of 2005, Nordea plans a major reorganization. Nordea wants to re-organize so that the bank will be headquartered in Sweden as a European Company with branches in the other three countries. Sweden is the largest of the four countries, but it does not dominate the others within Nordea; all countries play important roles in the bank and the bank plays important roles in all the four countries.

The formation of a European Company headquartered in Sweden with branches in Denmark, Finland and Norway is very much within the spirit of the Second Banking Directive of the EU. The principles of home-country control and deposit insurance apply to branches but not to subsidiaries, however. Host countries retain supervisory responsibility over subsidiaries and host-country deposit insurance applies. Thus, the reorganization of Nordea implies a substantial reallocation of supervisory and regulatory responsibility and risk. If Nordea's European Company approach proves successful for both the bank and the supervisors it may very well become the model for the future and unleash a wave of cross country mergers in Europe in particular.

The main goal of this paper is to evaluate the regulatory and supervisory issues arising from cross-border operations, with an emphasis on the Nordea case. The next section looks at cross-border activities and the relative advantages and disadvantages of subsidiary and branch structures in cross-border banking from banks' point of view. The third section examines regulatory problems that can arise from this activity, and the EU's approach to regulation, supervision and deposit insurance for cross border banking in comparison with the approach taken by regulators and supervisors in the United States. The fourth section deals with the special problems arising in the Nordea case, especially the conversion from a subsidiary arrangement to a branching arrangement. In Section V

alternative approaches to supervision of international branch banking are discussed: The Nordea case offers an opportunity to develop a supervisory structure and a legal framework for banks that enhances market discipline for large international banks. The legal and supervisory frameworks must pay particular attention to distress resolution and insolvency procedures for banks. If such procedures do not become credible and established ex ante it is unlikely that potential benefits from large scale cross-border banking organizations will become reality.

II. Cross-Border Activity in Branches and Subsidiaries

Enthusiasm for cross-border activities by banks has varied greatly over the years. Banks see profit opportunities in expanding across borders but also see difficulties in coordinating operations across national borders. Governments and regulators may see opportunities for knowledge transfer arising from hosting foreign banks but also threats to control and financial stability. Early empirical papers explaining cross-border activity dealt with U. S. banks expanding abroad or foreign banks expanding into the United States. For example, Goldberg and Saunders (1980) examined U. S. bank growth in Great Britain. Goldberg and Saunders (1981a) looked at the determinants of foreign banking activity in the U. S., and Goldberg and Saunders (1981b) analyzed the growth of foreign banks in the U. S. by organizational form. Grosse and Goldberg (1991) examined the growth of foreign banks in the U.S. by country of origin. Many other studies followed these and frequently used different country combinations, but most often still involved the U. S. The types of factors that were related to foreign bank growth included GNP, trade between the two countries, changes in regulations, foreign direct investment in manufacturing, and differences in country risk. Conventional wisdom says that banks initially expand abroad in order to follow their home-country customers' multinational activities. Though this explanation may be valid for banks' very first steps outside the home country, it is clear that foreign banks have substantial host-country oriented financial activity in many countries. After learning about a market by means of representative offices, many banks draw on their expertise there to expand into new fields.

International expansion has also been induced by regulation. The Eurodollar markets expanded in the 1960s partly as a result of American interest rate ceilings (Regulation Q), which could be circumvented by American banks accepting dollar deposits in branches in London. American commercial banks were also able to run investment banking operations in Europe when the Glass-Steagall Act prevented them from doing this in the U.S.

Although foreign banks have expanded their services in host countries after the initial establishment, they have, until recently, rarely become full-fledged local financial institutions. Even in some developing countries where foreign banks long have had retail operations and a substantial presence, they have focused on relatively large corporations with international activities. The factors hindering international expansion across the range of banking services are a combination of discriminatory regulation and practices in host countries, and costs of acquiring necessary local knowledge, particularly for engaging in retail banking. As long as foreign operations have been relatively specialized and small relative to the banking sector in the host countries, the foreign operations of, for example, U.S. banks in Europe and European banks in the U.S. have been organized sometimes as branches and sometimes as subsidiaries.

Only as a result of market reforms in Eastern and Central Europe have Western banks acquired dominant positions in foreign countries in response to liberal host-country policies with respect to foreign direct investment (FDI) in banking. These policies have enabled Western banks to obtain the necessary local expertise by acquiring whole financial institutions that often remain under local management. This type of expansion is motivated by benefits from Western banks' knowledge transfer in credit risk management, information systems, and capital markets.

The choice of a subsidiary structure in Eastern Europe is consistent with specific advantages of subsidiaries over branches.¹ First, Kahn and Winton (2004) point out that if the host country is considered riskier than the home country, the subsidiary structure insulates the parent bank from the host country risk. This argument presumes that the parent does not provide a full guarantee of the subsidiary to protect the parent's brand name. Second, host country deposit insurance schemes can be exploited more effectively

¹ Dermine (2005) reviews the arguments for and against branch- and subsidiary structures

in the form of risk taking if the subsidiary has an independent capital base without co-insurance offered by the parent's capital base. Third, local funding in capital markets can be made more accessible by separate listings of subsidiaries in host country stock markets. The trade in local stock markets increases the informativeness of stock prices according to Habib (2000). The international management literature points towards advantages of subsidiaries when local managerial resistance to acquisitions needs to be broken, and when local customers have strong preferences for dealing with local banks and local brands for cultural or legal reasons. All these arguments seem to have relevance in the context of the emerging market economies of Europe.

Disadvantages of subsidiaries relative to branches exist when economies of scale and scope can be exploited within a common organization across home and host countries. These conditions exist if the preferences for various financial services are similar across the countries so that knowledge of customers in one country implies knowledge of customers in the other. Under these conditions there are also cost savings from integrated accounting and information systems.

The Nordea expansion strategy has been made possible by relatively non-discriminatory policies (by EU standards) in the Nordic countries in recent years with respect to foreign banking acquisitions. There is controversy, however, about the appropriate approach to cross-border expansion in these countries. While Nordea's approach aims at integrating functions across the countries in the belief that economies of scale and scope are substantial, the approach taken by other banks has been to acquire a foreign bank as a subsidiary and to let it run as a separate business unit. To outside observers, the four Nordic countries look as similar to each other as almost any other combination of countries in the world. There is much anecdotal evidence, however, that the business cultures and regulatory approaches show substantial differences. Nevertheless, if the Nordea model for cross-border integration of similar size banks in similar size countries cannot work in the case of Nordea, then perhaps it cannot work anywhere.²

The strategy of functional integration is harder to implement in retail banking than in, for example, asset management. Nordea has changed its organizational charts many

² A companion paper analyzes Nordea's performance to date. See Goldberg, Sweeney and Wihlborg (2005).

times, indicating that management is uncertain about the appropriate organizational structure, and is perhaps learning by doing. The legal structure with subsidiaries in the four countries has not and does not coincide with the internal organization across countries and functions. The proposed reorganization into a branch structure is an attempt to create a legal structure that coincides more closely with the business organization.

III. Issues and Approaches to Regulation and Supervision of International Banks

When banks operate across national boundaries regulatory questions naturally arise. Who is responsible for regulating different aspects of the bank's operation: the home country regulator or the host country regulator? Who is responsible for supervision? What are the procedures for crisis management? Who is responsible for deposit insurance schemes for depositors in different countries?

Berger et al. (2000) review the literature on problems that can arise from cross-border mergers. Cross-border mergers can expand the coverage of the safety net and deposit insurance. More protection to institutions that grow large through cross-country mergers may lead to "too big to fail." As a bank becomes "too big to fail," moral hazard increases and the bank has an incentive to undertake riskier activities. The expansion of the safety net also may increase government protection for non-bank financial *activities*. Coverage may in fact be extended to non-bank financial *institutions* as well as the parts of banks engaging in these activities. Cross-border mergers and acquisitions may expose the government safety net to losses from operations in other countries. Depending on the relative size of the home and foreign operation, this exposure may become too large to be acceptable to Financial Supervisory Authorities (FSAs) and the political authorities behind them. Finally, consolidation may increase the difficulties and costs of coordinating regulatory response across countries if a large organization fails. In the EU the national central banks are the lenders of last resort and different countries may have different incentives to bail out different institutions, even though all are domestic, depending on the size of the institutions, fears of contagion, and political pressures from groups with a stake in distressed institutions. Goodhart (2004) and Kimminger (2004) emphasize the problems that arise when an international bank faces distress. Approaches

to resolution may differ in law and practice, and conflicts of interest may arise among FSAs and national governments.

Herring (2004) documents the types of problems that can arise in the case of cross-border financial institutions; he argues that large financial conglomerates can appear “too complex to fail.” Management has difficulty in coordinating activities across country lines and supervisors have difficulty supervising these cross-border institutions. When a problem arises, supervisors have had significant problems in resolving the situation. He analyzes several cases where financial conglomerates have combined banking with another type of financial activity. The cases involve Bankhaus Herstatt, Drexel Burnham Lambert, the Bank for Credit and Commerce International (BCCI), Barings PLC, and Long Term Capital Management. Even cross-border mergers that only involve banking can cause complex management and regulatory problems.

Vision vs. reality in the EU

The EU concept of a single banking license for branches within the EU along with the principles of home-country control and home-country deposit insurance has been mentioned. This EU approach makes it possible to have competing banks in one country with different deposit insurance coverage and subject to different rules by home country law and regulation although high-coverage countries can offer foreign banks “top-up” insurance coverage. Competition between banks subject to different rules is consistent with the principle of mutual recognition (of regulation and legislation), and it is expected to lead to competition between different institutional structures. There is also a potential conflict of interest between host-country supervisors' responsibility for financial stability and home country control over host-country branches when the latter constitute a large part of the host country's banking system.

The mentioned EU principles do not seem to have great support among EU governments in the area of banking, judging from the active discouragement of cross-border acquisitions in several cases and the absence of important cross-border banking activities in branches. One example of discriminatory practices against foreign banks is the case several years ago when a Spanish bank (Banco Santander) was not allowed to acquire a Portuguese bank. Banco Santander was ultimately allowed to acquire a part of the Portuguese bank. Further, the EU Commissioner for the Internal Market wrote a letter

on February 8, 2005, to the Italian government asking it to “correct the impression that it is has been and is trying to prevent acquisitions of domestic banks by foreign banks.”³ Since then, a scandal has been brewing around the behavior of the Banco d’Italia and its president Antonio Fazio in connection with foreign banks’ take-over attempts. In one case, ABN-AMBRO was competing with an Italian bank to acquire Banco Antonveneta and, in a second case, a Spanish bank, BBVA, tried to acquire Banco Nazionale del Lavoro. Both attempts failed. It has not been proven that rules were broken by Italian authorities but the foreign banks claim that delays in the handling of their applications favored domestic bidders. Other cases of alleged discrimination against foreign banks involve decisions by France and Belgium.

Significant cross-border transactions have occurred within the EU. The mergers behind Nordea represent one case. The Dutch ING Group has acquired banks in Belgium and Germany, and the German HypoVereinsbank (HVB) has acquired an Austrian bank. In all cases, the acquired banks have remained separate legal entities in the host countries so far. .

When host country activities are performed within subsidiaries the home country is responsible for supervision of the *consolidated* entity, while the host country supervises the *local* bank. Deposit insurance coverage becomes a host country responsibility. The home- and host-country supervisors agree on information sharing in a Memorandum of Understanding. In principle, the host-country supervisor must keep the home-country supervisor informed about risk-taking in the subsidiary while the home-country supervisor must disclose only “relevant” information about the whole entity. Thus, if there are problems in the bank outside the host country, its supervisor need not be informed.

The division of responsibility between home- and host-country supervisors has led to fears in Eastern Europe that a home-country supervisor may collude with a problem bank to shift losses to a host country’s subsidiary or remove assets from the host country before allowing the host country subsidiary to fail. Thereby bailout or resolution costs would be shifted to the host country. Facing this risk, supervisors in Eastern and Central Europe often require subsidiaries to hold more capital than specified under the Basel

³ *The Economist*, February 19, 2005.

accord.⁴ The risk of collusion between the home country supervisor and the parent bank at the possible expense of host countries is not limited to Eastern Europe, of course; it is particularly acute there, however, because such a large share of the banking sector is foreign controlled.

In June 2004, the EU Commission presented a proposal for a new Capital Requirement Directive (CRD 3) based on Basel II. The new proposal includes a shift in the balance of responsibilities of home and host country supervisors of banks with foreign subsidiaries. Specifically, when it comes to validation of risk evaluation models to be used to determine capital requirements under the Internal Ratings based approach, the *home* country supervisor is given the final say if the two supervisors cannot agree within six months. At the same time the deposit insurance responsibility for the subsidiary remains with the *host* country supervisor. If this proposal is implemented, the reasons for the host country supervisor to distrust the home supervisor may be strengthened further.⁵

A solution to the problem of Eastern and Central Europe would seem to be to allow foreign banks to operate host-country branches. Thereby, supervisory responsibility would rest entirely with the home country, and deposit insurance for all depositors in all branches would be the responsibility of the home country. From a bank's point of view, however, the branch solution may be inconsistent with the bank's strategy relative to the host country. If the strategy is to operate the host country bank as a truly local bank under a local name with local management and internal culture, then a subsidiary structure is more appropriate.

In the case where the bank operates in host countries in branches under home-country control, a different type of supervisory conflict may arise; in particular when the branches are of systemic importance to the host country. The host country is not certain that the home supervisor will give appropriate weight to the interests of the host country when the bank approaches distress. For example, to cut losses the home supervisor may force the bank to shut down some operations quickly. If these operations are abroad and sizeable, the host country may be subject to financial disruption beyond its control.

⁴ See European Shadow Financial Regulatory Committee (2004a).

⁵ See European Shadow Financial Regulatory Committee (2004b).

Essentially, the host country loses control over the bail-out policy for the banks operating within its jurisdiction. We discuss this issue in more depth in Section V.

The lack of acceptance within the EU of mutual recognition of home country control over branch networks can be explained partly by protectionist attitudes, but both home- and host-countries have legitimate worries as well. If foreign branch operations become large, home country governments and supervisors are expected to take responsibility for deposit insurance of both domestic and foreign bank operations. The host country supervisor concerned with financial stability may fear that local branches will be shut down early and quickly when problems arise in the bank.

The other side of the coin is that the incentives of home country authorities to bail out an international bank with foreign branches are weaker than the incentives to bail out a domestic bank of similar total size. Furthermore, the home country authorities have incentives to charge sufficiently large deposit insurance premia to be able to cover potential losses if the international bank fails. Thus, the subsidy component in the banking system could decline. The international banks may become Too Big To Save, while large domestic bank tend to be Too Big To Fail.

The U.S. Approach

It is useful to examine the approaches to foreign bank regulation in the U.S. relative to the EU. The fractured nature of the American regulatory structure for financial services is well known. The responsibilities of national and state authorities, and of the Fed, the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC) are partly overlapping. The FDIC has emerged as the primary regulator, however, in particular for banks operating across state borders. An important difference relative to the EU is that a strong interstate (national) regulator and supervisor exist in the U.S.—the FDIC.

The American approach to foreign banks operating in the USA can be characterized as “national treatment” as opposed to mutual recognition. Subsidiaries of foreign banks operate under U.S. rules and regulations, and they participate in the U.S. deposit insurance system. Branches of foreign banks exist but they are discouraged. These branches are subject to U.S. rules for deposit insurance and their assets are “fenced in” to cover claims in the U.S. Thus, the U.S. does not recognize the home country’s

responsibility for a bank's operations in the U.S. As a result branches of foreign banks in the USA are de facto similar to subsidiaries.

An important aspect of the American regulatory structure is the existence of distress resolution procedures known as “Prompt Corrective Action”. These procedures refer to the management of banks in or approaching distress. The FDIC requires actions by a bank at specific trigger capital ratios. These actions become more severe and constraining as the bank’s capital shrinks. The system is designed to protect the deposit insurance fund and taxpayers, and to provide incentives for banks’ management to avoid distress situations. The deposit insurance has relatively high coverage and it guarantees rapid payments to depositors in case a bank fails. Taken together the regulatory structure should offer credible guarantees of insured deposits and lower likelihood that a distressed bank must be bailed out under ad hoc emergency procedures. Thereby, the credibility of *non-insurance* of some creditors is enhanced. Angkinand and Wihlborg (2005) argue that this credibility of non-insurance is a prerequisite for effective market discipline in banking.

IV. Nordea and issues of supervision

The Nordea Group was established in 2000 but derives its origin from Nordic-region banks and insurance companies that go as far back as the early nineteenth century. The first cross-border merger took place in 1997, when Merita Bank (which was Finnish) and Nordbanken (Swedish) formed MeritaNordbanken. The merger of MeritaNordbanken and Unidanmark (which was Danish) in 2000 was followed by the acquisition of the Norwegian bank Christiania Bank og Kreditkasse in late 2000 to create the largest financial institution in the Nordic area. Further, during 2001 Nordea acquired Postgirot Bank (Swedish). Since December 3, 2001, the entire Group has operated under the Nordea brand.

Nordea presents a special problem for management and for regulators. Nordea has grown from the combination of four banks in each of four countries. None of the banks is greatly larger than the others and none of the countries is so large that it dominates the other countries. Currently the organization is built around bank subsidiaries in each country. This gives primary regulatory responsibility to each of the

four home countries for the bank subsidiary located in that country. There can be spillover effects, however, from problems with the bank in a country on the other subsidiaries. Furthermore, Nordea engages in considerable non-banking activity done in all the countries.

Differences in tax systems and regulation in the four countries have created serious challenges for both Nordea and the supervisors. Nordea must adjust its legal organization and accounting systems relative to different tax systems. The value-added tax systems in particular have created a tax burden when services are offered cross-border between separate legal entities within a functionally integrated organization.⁶ The supervisors also must adjust their activities relative to Nordea's functional organization.

Nordea has apparently found it difficult to achieve a legal structure that is satisfactory both from the point of view of achieving strategic objectives and from the point of view of national tax and regulatory authorities. The bank has changed its organizational charts frequently, sometimes several times in a year.

The latest proposal is to convert the organization to one where the bank is headquartered in Sweden, the largest of the countries, and the other countries would have branch offices. As mentioned in the previous section, this proposal raises new issues for supervisors stemming from the individual supervisors' responsibility for financial stability in their countries when large parts of their banking systems are branches of a foreign bank. What if branches in one country have difficulties? How are they bailed out—if at all? What if the bank as a whole faces distress or insolvency? What roles are played by different supervisors and deposit insurance systems?

Table 1, based on a Bank of Norway publication, shows traditional perceptions of a host country's responsibility towards foreign branches and subsidiaries. This division of supervisory responsibility in the EU was discussed above. Table 2, based on a table from the same source, also illustrates a very important point: Regulators are more likely to have a common interest in supporting a cross-border bank in a financial crisis if it is considered important in both countries (Too Big to Fail).

⁶ Nordea executives claim that savings from reduced value-added tax payments represent a major benefit of creating a branch structure across borders.

Even in Nordea's current structure the regulators could potentially face a difficult problem if a subsidiary bank in one country encounters trouble. Nordea itself likely would try to prop up that bank by providing funding from the other banks. At what point, however, does Nordea give up and let the one troubled bank fail? The regulator from the country of the failing bank would have the responsibility of saving the failed bank or helping it in transition. Does the regulator call for help from the other banks in the Nordea organization and does it ask the other regulators to step in and help? Regulators have devised schemes for these scenarios, but frequently something arises that was totally unanticipated. And, as noted above, it is possible that the parent bank and the home country supervisor might collude to shift bad loans to the failing subsidiary and thereafter to abandon it.

With the branching model, different complications can arise. If loans in one country default widely and depositors withdraw their funds, what does the home office in Sweden do to protect the whole organization? Does management close up shop in one country and forget about that country in the future? In the case of Nordea, power and ownership is divided into four relatively equal shares by country. Thus, abandoning one country is probably not an option within the framework of Nordea, though it might well be so in the future for Nordea or another bank.

Under branching, primary regulatory oversight for Nordea will be in Sweden along with responsibility for the deposit insurance scheme for the whole bank. How much will the Swedish authorities care about what happens in one of the other countries? Is Nordea becoming Too Big To Save? Will the four national regulators be able to coordinate policies? Is the supervisory regime envisaged by the EU appropriate for banks of Nordea's type? These are important issues that the regulators must consider as they decide whether to approve the proposed reorganization of Nordea.

The regulatory regime facing Nordea in its current subsidiary organization is one of cooperative supervision, but deposit insurance systems are country specific. This organization of supervision represents an attempt to integrate the supervision in order to correspond with Nordea's functional organization. To supervise effectively, the four Nordic supervisors have organized a Nordea committee with involvement from all countries. This committee has then created a number of joint subcommittees. It is hard for

outsiders to tell how well this structure works, but there are reasons to be somewhat skeptical. One reason is that the four countries' supervisory approaches are as different as the four countries' business cultures. Sweden's FSA is considered relatively lax by the other countries' FSAs, because it avoids very detailed supervision of the balance sheet in favor of supervision of procedures and incentives in the organization. Finland and Denmark on the other hand have the reputation of being more detail oriented and hence of intervening more in decisions affecting risk. Nordea spokespersons argue that the total time spent with supervisors is greater now than the total time spent by the four individual banks before the mergers. Problems of dealing with four tax systems, however, seem to be greater than the problems of dealing with supervisors.

Another problem with the current structure is that Nordea is large enough in each of the countries to be considered Too Big To Fail. In Finland, its market share is perhaps 40 percent; the smallest share is in Norway with 15 percent. Thus the involvement of all four countries in the regulation and the supervision implies that a relatively broad bail out is the only feasible consensus solution in case of distress.

On the face of it the branch structure, if implemented, simplifies both Nordea's organization and the supervisory responsibility. Clearly, greater correspondence between legal and functional organizations is an advantage from an internal efficiency point of view. The regulatory problems, however, require more discussion.

V. Towards Enhanced Market Discipline with a Branch Organization

In this section we argue that the implementation of the EU regulatory model for home-country control of host-country branches in the Nordea case sets the stage for substantially enhanced market discipline in banking. We argue also that the model to be effective requires credible distress resolution and insolvency procedures for banks.

Nordic supervisors face a choice among different "models" for supervision of a reorganized Nordea as a bank with headquarters in Sweden and branches in Denmark, Finland and Norway. The following "models" are listed in Table 3:⁷

(i) They can continue with the current inter-supervisory committee approach, while depositors are covered by host country deposit insurance systems.

⁷ The table assumes that the European Commission accepts the chosen organization.

- (ii) The inter-supervisory committee approach continues, while depositors in all host country branches become covered by the Swedish deposit insurance system. In this case the Swedish supervisor would be the lead supervisor.
- (iii) Supervisory responsibility becomes entirely Swedish, while depositors in all host country branches become covered by the Swedish deposit insurance system.
- (iv) A fourth model would place supervisory responsibility in Sweden and deposit insurance in the host countries.
- (v) Establish a Nordic supervisory authority and deposit insurance system.

In deciding among these alternatives, supervisors must worry about information availability, costs of supervision, crisis management procedures, and incentives of supervisors created by their responsibility relative to insurance systems and taxpayers. The chosen supervisory structure could also influence the incentives facing Nordea. Finally, supervisors need to ask whether each of the supervisory structures could be enhanced through regulatory and legal innovations.

The idea of a Nordic supervisor seems far-fetched. If anything, a European Union (EU) or European Monetary Union (EMU) supervisor could be envisioned for the future, but such an institution is far off. Further, note that Norway is not a member of the EU and that only Finland is a member of the EMU. For the foreseeable future, national supervisory authorities are the only basis of a realistic institutional structure. Similarly, the lender of last resort (LOLR) function is a national responsibility of the central banks.

Model (iv)—supervisory responsibility in Sweden and deposit insurance in the host countries—can also be ruled out, on the grounds that the assignment of supervisory responsibility does not coincide with risk-taking of deposit insurance systems and of the tax-payers who lie behind the insurance systems. In the U.S., the branches of foreign banks are covered by the domestic deposit insurance system, but U.S. regulators place restrictions on these branches that make them, in effect, U.S. banks, and thus the potential advantages of branches are lost.

The Swedish FSA seems to favor a structure between (i) and (iv)—in (i) there is an inter-supervisory committee, and depositors are covered by host country deposit insurance systems; in (iv) supervisory responsibility is in Sweden, and deposit insurance in the host countries. The Swedish FSA is willing to take primary supervisory

responsibility with substantial involvement of the other FSAs. It is unwilling, however, to have all depositors covered by the Swedish deposit insurance system—the risk that Swedish taxpayers faced would potentially be very large. Note that the EU deposit insurance directive places responsibility for deposit insurance in the country of incorporation—in this case, Sweden. Thus, it is unlikely that Sweden can avoid responsibility for deposit insurance for the whole bank. Thereby, the choice would be restricted to alternatives (ii) and (iii).

Denmark, Finland and Norway are likely to prefer either model (i) or model (ii)—in (i) there is an inter-supervisory committee, and depositors are covered by host country deposit insurance systems; in (ii) there is an inter-supervisory committee, and depositors in all host country branches become covered by the Swedish deposit insurance system. If EU rules prevent any solution where deposit insurance is not a Swedish responsibility alternative (ii) would be the preferred alternative. Thus, it would seem that all countries should be able to agree on alternative (ii). Incentive compatibility is a problem, however, if the host countries for branches do not have to carry losses of the deposit insurance system. Incentive compatibility can be enhanced in case these countries provide deposit insurance coverage on top of the Swedish coverage.

Concentrating all regulatory responsibility in one supervisor, the FSA of the country responsible for the insurance of all the depositors [model (iii)], would create the most incentive compatible supervisory structure. The organization of regulation and supervision can also become more transparent and simple, with clear assignment of responsibility. On the one hand, because the bank would have most of its activities outside the home country, it may become “Too Big to Save” On the other hand, statements from the supervisor to the effect that depositors and other creditors are not protected beyond the explicit, partial insurance scheme become credible. Thereby, market discipline is likely to have a strong effect on the bank’s behavior with respect to risk taking and capital structure and moral hazard problems in the bank’s risk taking would be reduced substantially. These advantages do not come automatically, however; since substantial conflicts of interest among national regulators and central banks can arise. For example, market discipline requires that the host countries for the branches do not provide implicit guarantees by signaling that they are likely to contribute to a bail-out in a

distress situation. The explicit as well as the implicit safety net determines whether the de facto responsibility for the safety net coincides with the formal assignment of responsibility under alternative (iii).

The main concern with model (iii) for the supervision of the branch structure is that the FSAs in the host countries (Denmark, Finland and Norway in the Nordea case) will not be willing to live by the principle of mutual recognition, that is, to leave the responsibility with the home country FSA (Sweden); the other supervisors may not be willing to simply give the Swedish FSA a green light for supervision of large parts of their banking systems because formally they remain responsible for financial stability on the national level.

The greater potential efficiency of the financial system under model (iii) would not be realized without reforms of supervisory organizations and crisis management procedures. The favorable outcome requires that the non-Swedish FSAs rely on the Swedish FSA to treat all branches even-handedly in a crisis situation, and that they have faith in the Swedish FSA as supervisor and head crisis manager. Further, the host-country FSAs need to commit to accept the role of market discipline. If host countries do not have faith in the home-country regulator, and are not willing to let the home-country regulator call the shots in crises, then the host country FSAs may intervene in a crisis to take over and bail out the branches in their countries. If markets expect this to happen, then market discipline is going to be weak and banks' incentives become biased towards excessive risk taking. In order to prevent such an outcome the following aspects of the supervisory and crisis management framework need strengthening:

1. The Swedish FSA's rules for bank distress resolution and insolvency need to be clear and credible ex ante. At a minimum, these rules need to include binding measures, commonly called "Prompt Corrective Action," that specify the measures that will be taken when the capital ratio of the bank falls below certain triggers.
2. The rules for "Prompt Corrective Action" must assure all countries involved that the intervention will follow rules that do not discriminate between branches and creditors in different countries.
3. For the home country supervisor to obtain and retain credibility as the supervisor of branches in all countries, the FSAs in the host countries need to be informed about *all*

supervisory activities and the results of these activities. The responsible supervisor must be able to obtain local expertise from the other supervisors upon request. Responsibility must not thereby be shifted towards the host countries, however.

4. The FSAs in the host countries must contribute to the credibility of the regulatory regime by making it clear that they take no regulatory, supervisory, or crisis resolution responsibility, but they are committed to the ex ante determined rules for Prompt Corrective Action and partial deposit insurance.

5. Host country governments must assure their FSAs of sufficient independence that markets believe that governments will not in times of crisis override FSA commitments.

VI. Conclusion

To realize the full advantages of cross-border branch organizations, supervisors, central banks and governments must come to accept the principles of home country control of banks, mutual recognition, and competition between different degrees of deposit insurance coverage depending on a bank's home country. This acceptance does not come easy and requires important institutional reforms of distress resolution procedures in particular. "Prompt Corrective Action" procedures could be the minimum requirement that enables host country supervisors to trust a home country supervisor with the task of supervising and managing crisis in important parts of their banking systems.

In the absence of substantial reform of distress resolution and insolvency procedures branch structures in cross-border banking is likely to be supervised jointly by authorities in all countries involved. In times of crisis the only available solution that all supervisors can agree on with sufficient speed is likely to involve a bail out of the distressed bank. Thereby, implicit guarantees of banks' creditors are likely to remain strong and market discipline on bank behavior weak.

References

Angkinand, A. and C. Wihlborg (2005), "Bank Insolvency Procedures and Market Discipline in European Banking", in Oxelheim, L., *Transparency and Cost of Capital in Europe*, Elsevier-North Holland, forthcoming

Berger, A.N, R. DeYoung, H. Genay and G.F. Udell (2000), "Globalization of Financial Institution", *Brookings-Wharton Papers on Financial Services*

Borchgrevink, H. and T.G. Moe (2004), "Håndtering av finansielle kriser i grensekryssende banker" (Management of Financial Crises in Cross-border banks), Bank of Norway.

Dermine, J. (2005), "European Banking Integration: Don't Put the Cart Before the Horse", presented at FRB Chicago-World Bank Conference on *Cross-border banking*, Oct 6-7..

The Economist (2005), February 19.

European Shadow Financial Regulatory Committee, (ESFRC) (2004a), "Challenges to Financial Regulators in the Accession Countries", May 14.

------(2004b), "Towards New Bank Capital Requirements in Europe" Oct 24.

Goldberg, L.G. and A. Saunders (1979), *The causes of US bank Expansion Overseas, The Case of Great Britain*, New York University, Graduate School of Business Administration, New York

------(1981a), "The Determinants of Foreign Banking Activity in the USA", *Journal of Banking and Finance*, Vol 5, No 1, 17-32.

------(1981b), "The Growth of Organizational Forms of Foreign Banks in the US; A Note", *Journal of Money, Credit and Banking*, Vol.13, No 3, 365-74.

Goldberg, L.G., R. J. Sweeney and C. Wihlborg (2005), "Evaluating the Nordea Experiment: Evidence from Market and Accounting Data", LEFIC Working Paper, Copenhagen Business School

Goodhart, C.A.E. "Multiple Regulators and Resolutions". Mimeo, Financial Markets Group, LSE.

Grosse, R, and L.G. Goldberg (1991), "Foreign Bank Activity in the United States; An Analysis by Country of Origin", *Journal of Banking and Finance*, Vol. 15, No 6, 1093-1112.

Habib, M. A., D.B. Johnsen and N.Y. Nail (1997), "*Spinoffs and Information*" Journal of Financial Intermediation, Vol.6, No 2, 153-176

Herring, R. (2004), "International Financial Conglomerates; Implications for Bank Insolvency Regimes", Working Paper, The Wharton School of the University of Pennsylvania.

Kahn and Winton (2004)

Kimminger, M.H. (2004), "Deposit Insurance and Bank Insolvency in a Changing World: Synergies and Challenges". IMF Conference, May 28, Washington, D.C.

Lastra, R. (2003), "Cross-border Bank Insolvency: Legal Implications in the Case of Banks Operating in Different Jurisdictions in Latin America." Journal of International Economic Law 6(1).

Mayes, D. G. (2004), "The Role of the Safety Net in Resolving Large Cross-border Financial Institutions", Bank of Finland.

Søderberg, A.M. and E. Vaara (eds) (2003), *Mergers Across Borders; People, Culture and Politics*, CBS Press, Copenhagen.

Table 1. Traditional perceptions of *host*-country responsibilities towards *foreign* branches and subsidiaries.

Authorities in the host country are responsible for:	Subsidiaries	Branches
Solvency Assessment	X	
Liquidity Support (Central Bank)	X	X
Net capital support (Political authorities/Department of Finance)	X	
Investment Protection (Protection Fund)	X	(X) ¹

¹ Within the European Economic Area branches of credit institutions from another EEA state are entitled to buy supplementary coverage in the host country's investment guarantee fund if the host country's investment guarantee scheme is better than the scheme in the home country of the parent of the branch.

Source: Table 1 is based on "Håndtering av finansielle kriser Iigrensekryssende banker" (Management of Financial Crises in Cross-border Banks) by Henrik Borchgrevink and Thorvald Grung Moe, Bank of Norway.

Table 2. Home country's and host country's viewpoints on support in a financial crisis in a cross-border bank.

Host country → Home country ↓	The bank is a <i>major</i> bank in the host country	The bank is a <i>minor</i> bank in the host country
The parent bank is a <i>major</i> bank in the home country	1. Common interest in support	2. Different viewpoints on support Home: Yes. Host: No.
The parent bank is a <i>minor</i> bank in the home country	3. Different viewpoints on support Home: No. Host: Yes.	4. Common interest in no support

Source: Table 2 is based on "Håndtering av finansielle kriser Iigrensekryssende banker" (Management of Financial Crises in Cross-border Banks) by Henrik Borchgrevink and Thorvald Grung Moe, Bank of Norway.

Table 3: Alternative supervisory and deposit-insurance approaches.

1. *Inter-supervisory committee* approach

Depositors covered by *host-country* deposit insurance systems
(current system)

2. *Inter-supervisory committee* approach with the Swedish supervisor in a leading role.

Depositors in all host-country branches covered by the *Swedish* deposit insurance system

3. Supervisory responsibility entirely *Swedish*

Depositors in all host-country branches covered by the *Swedish* deposit insurance system

4. Supervisory responsibility entirely *Swedish*

Depositors covered by *host-country* deposit insurance systems

5. *Nordic* supervisory authority

Depositors covered by a *Nordic* deposit insurance system