"HOME COUNTRY CONTROL AND MUTUAL RECOGNITION"

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Summary

The '1992 Internal Market' programme provides that regulation and supervision will be guided by the principles of home country control and mutual recognition.The issue raised in the paper concerns the application of these two principles to banking services.Is there anything special in banking that would justify a different approach ?

The European Commission has worked for nearly thirty years on the integration of banking and financial markets.Freedom of establishment and entry was achieved in 1973,but further efforts to harmonize banking regulations and promote cross-border services proved to be very slow .This process led to a genial idea incorporated in the 1985 White Paper on the Completion of the Internal Market : The opening of markets prior to harmonization.Regulation and supervision are guided by the principles of home country control and mutual recognition according to which each country will accept the regulation and supervision enforced by other countries on their domestic firms operating abroad.These principles are very broad : they apply to all products,banking and financial services included.The issue raised in this paper concerns the application of these two principles to banking services.Is there anything special in banking that would justify a different approach ?

In reference to the economic theory of regulation,we analyse the characteristics of banking products which call for public intervention.This leads to a discussion of deposit insurance,lender of last resort and the links between banking,insurance,industry and commerce.

The main conclusions of the paper are as follows.The major

reason for intervention in banking is the need to ensure the stability of banking markets.This does not imply the systematic protection of depositors.The current design of deposit insurance systems and lender of last resorts imply that the principles of home country control and mutual recognition must be complemented with host country supervision.As long as national monetary authorities do not delegate their power to a supranational authority,they should keep full supervisory responsibility for their domestic markets.Moreover,fair competition is likely to entail further harmonisation of the coverage of the various deposit insurance systems and of the links between banking,commerce,insurance and industry.

The paper is organized as follows.Section One summarizes the main charactersitics of the single market proposal.Section Two reviews the specific characteristics of banking services calling for public intervention.Finally,Section Three evaluates the European proposals from the perspective of their ability to ensure the stability of banking markets.

Section One : European Banking,from 1957 to 1992

To understand fully the prudential issues at stake and the process of European banking integration,it is useful to review the major actions undertaken by the Brussels Commission and the

Council of Ministers.Three time periods can be distinguished : Deregulation of entry on domestic markets from 1957 to 1973, various attempts towards harmonization of banking regulations from 1973 to 1983 and the recent proposal of freedom of cross-border services, single banking licence,home country control and mutual recognition.

Deregulating entry 1957-1973

On july 1965,the Commission made a proposal for a directive on the Abolition of Restrictions on Freedom of Establishment and Freedom to Provide Services in Respect of Self-employed Activities of Banks and other Financial Institutions.Adopted by the Council in june 1973,this directive ensures the equal treatment of national and others firms of Member States on entry in domestic markets and on conditions at which banks are submitted during their activity.As Clarotti (1984) notes,very little discrimination remains as to entry in Member States.However, the objectives of the initial Treaty were still far from being met.Although the original Treaty and the 1973 directive called for it,international competition through the supply of cross-border services was severely limited by restrictions on capital flows.Furthermore,there was no coordination of banking supervision,so that banks operating in different countries could be subject to different rules.This led to the second phase of attempts to harmonise regulations.

1973-1983 Harmonization of banking regulations

Progress in harmonization came in 1977 with the adoption of the First Directive on the Coordination of Laws,Regulation and Administrative Provisions Relating to the Taking up and Pursuit of Credit Institutions.This directive establishes a definition of credit institutions (article 1) :"Undertaking whose business is to receive deposits and other repayable funds from the public and to grant credit for its own account".The principle of Home Country Control was established.The supervision of credit institutions operating in several Member Countries will gradually be shifted from the host country to the home country of the parent bank.The 1977 directive is a first step towards the harmonisation of regulation.It is a general programme ,which, without providing any specific regulation,calls for further directives.

After the 1977 first banking directive and the mentionned directives,the European banking markets were still far from full integration for four major reasons :

-a bank wishing to operate in an other country still had to be authorized by the supervisors of the other country.

-it remained subject to supervision by the host country and its range of activities could be constrained by host country laws

-in most countries,branches had to be provided with earmarked endowment capital as if it were a new bank.

-finally,as already mentionned,the supply of crossborder

services was severely impaired by the restrictions on capital flows.

The task of full harmonisation of national regulations seems to be a tentacular task which prompted a new approach towards European integration.

The completion of the internal market by 1992 : 1983-1992

Following various European Councils,the Commission proposed at the Milano meeting in 1985 its White Paper on the completion of the internal market by 1992.In short,the Paper calls for the removal by january 1st 1993 of the physical ,technical and fiscal barriers in all industries.

In the context of banking,the White paper calls for a single banking licence,home country control and mutual recognition.These principles are incorporated in the 1989 second banking directive.All credit institutions authorized in one European country will be able to establish or supply financial services without further autorization.They will be able to undertake all the activities listed in the annex of the second directive provided that these activities are not forbidden by the home country supervisor.

The list includes most activities of universal banks,the delivery of insurance services excepted.The directive calls for home country control on solvency and large exposure but recognize explicitly that host country regulation would apply

for monetary policy reasons and .or market position risk.Recognizing that full competition requires a fair level playing field and minimal harmonization of regulation,the second banking directive calls for minimal equity (5 millions ECU),supervisory control of major shareholders and of banks'permanent participation in the non-financial sector.
The second directive is accompanied by two recommendations on large risk exposure and on deposit insurance and by proposals for directives on reorganisation and winding up, own funds, solvency ratios and the account of foreign branches.

From this review of the directives,recommendations and proposals for directives,it appears that the objective pursued by the European Commission is threefold : free entry and provisions of financial services throughout the Community,the establishment of a fair level playing field with single banking licence,home country control,mutual recognition and minimal harmonisation on equity,accounting,ownership and participation in the non-financial sector and ,finally,consumer protection.In this respect, references (f.i. the 1985 White Paper or Clarotti,1987) are often made to the European Court of Justice case 'Cassis de Dijon' according to which control on the quality of a product is warranted but can be met fully by the home country supervisor.However,references are also made to the 1986 non-life insurance Court case according to which control

by host authorities can be accepted as long as they are justified on the ground of the 'public interest'.A second major illustration of the perceived need for consumer protection is the directive and recommendation on deposit insurance :

"Member states shall ensure that the deposit-guarantee schemes that exist in their territory cover the deposits of branches of institutions having their head office in another Member States. As a transitional measure,pending entry into force of a deposit-guarantee scheme in all Member States,the latter shall ensure that the deposit guarantee scheme , in which the institutions that have their head office in their territory take part,extend cover to deposits received by branches set up in host countries within the Community which have no deposit-guarantee scheme,under the same conditions as those laid down to guarantee deposits received in the home country" (article 16).

From the reading of the proposals for directives,it appears that one of the major reason for public intervention in banking is the premisse that consumers of financial services need to be protected.In order to assess the European framework,it is useful to review the banking literature and analyse the sources of potential market failure and the economic need for banking supervision.This the object of the second section.

Section Two : the Economics of Banking Regulation

Following the approach proposed in Baltensperger-Dermine (1987,1989),we review the major services provided by banks and analyse the potential sources of market failure.

Although the services provided by banks are interrelated,it is convenient to distinguish four categories : portfolio management,payment(transmission) mechanism ,risk sharing and monitoring or information-related services.

Portfolio management : at low cost,investors can acquire a diversified portfolio of liabilities issued by deficit spending units.The pure case is the SICAV,mutual fund or unit trust which allows the holder of a share to have access to a diversified portfolio of liabilities.

Payment mechanism : a second role for banks in the economy is the management of the payment system,that is to facilitate and keep track of transfers of wealth among individuals.This is the bookkeeping activity of banks realized by debiting and crediting accounts.

Risk sharing services : An essential function of banks is to transform the risks faced by the parties,that is to supply risk sharing contracts.First, banks not only provide a diversified asset,they also organize efficiently the distribution of the risky income earned on the asset pool.The deposit holders (the

depositors) receive a fixed payment while the shareholders receive the residual income.An other insurance service includes liquidity insurance (option for the deposit holder to withdraw quickly at face value).

Monitoring or information-related services : Banks perform a useful function in reducing the cost of screening and monitoring borrowers.As Diamond (1984) has shown,private information held by borrowers result in contracting problems and the delegation of screening and monitoring to banks is an efficient allocation mechanism.In addition to the classical lending function of banks,one can include in the information-related services most of the 'investment banking' activities such as underwriting and distribution of securities,trust or fiduciary services,merger and acquisition and risk/ treasury management.

As has been argued in the literature (f.i.Fama,1980),if banks were to provide only the first two services -portfolio and transmission-,there would be no special need for banking regulation.However the recent literature on insurance and monitoring services shows that the contract that emerges- illiquid loans financed by short term deposits- creates a potential market failure and a need for public intervention.Three independent explanations can be advanced : the public good character of information gathering and monitoring, the macroeconomic externality resulting from a bank default and the potential for bank runs and systemic crisis.

Information and consumer protection

The first argument is that the evaluation of bank risks is a costly activity which has the nature of a public good.Once it is produced,it is available to consumers at very low transfer cost.As such the monitoring and evaluation of banks should not be undertaken by each depositors but could be delegated to a public agency or a private rating firm.Furthermore,since small account holders may find the cost of interpreting the rating high and/or since they care about risk free deposits only,two alternatives could be developed.The first is to have deposit insurance.The second is to create risk free banks,that is intermediaries investing all deposits in risk free securities.Depositors would have the choice between banks offering a higher but risky return and those providing quasi-risk free deposits.

Our view on public information is that, in this respect, the banking industry does not differ much from any other industry.The major difference is that a large set of depositors may prefer a risk free deposit.As such,this does not require public intervention besides what is required for the securities industry in terms of disclosure of information.

Macro-domino externality

The second possible source of market failure is that the insolvency of one bank or group of banks (domino effect) is costly because information on borrowers is being lost.Borrowers would need to turn to other banks at more expensive credit terms.The externality does not arise from the loss of information per se -this is a private cost and borrowers should deal with safe banks- , it comes rather from a macroeconomic effect which is not internalised by the borrower.More expensive credit terms imply lower investment and unemployment.Although it is likely that large failures in the banking industry would produce this effect (Bernanke,1983),we find one reason to disregard this argument.Insolvent banks are taken over by other banks in most cases , precisely to avoid the costs arising out of losses of information.Therefore,one has to rely on other sources of market failures to justify permanent banking regulation.

Bank runs

This argument , recently formalised by Diamond-Dybvig (1983) and further expanded in Postlewaite-Vives (1987) ,Jacklin-Bahattacharya (1988) and Freeman (1988), is that an

important activiy of banks is to finance illiquid assets with short term deposits.This creates the potential risk that savers run to withdraw their funds.A run can be triggered by a bad news about the value of bank assets or by any unexplained phobia.In both cases,there is a cost since illiquid assets may have to be sold at a loss.Moreover,a bank failure could eventually trigger a signal on the solvency of other banks,leading to a systemic crisis .A market failure occurs because a cooperative solution among depositors cannot be enforced.Collectively,there is no incentive to run but ,individually,there is the incentive to be the first on the line to collect the deposit at full face value.In our view,it is the financing of illiquid assets with short term deposits and the potential for bank runs which explains the need for public intervention and the establishment of a safety net to guarantee the stability of the financial system.

Section Three: Should Home country control and mutual recogniton apply to Banking ?

There is a striking difference between the approach taken by the European regulators and the rationale for banking

regulation discussed in the literature.Leaving aside the freeing of entry and the development of fair competition,banking regulation seems to be perceived as a necessity to protect consumers against losses.In contrast,the banking literature is not concerned with risk per se.In an efficient market, as long as information flows properly,the risk will be priced into higher deposit rates and investors will have a menu ranging from risk free to 'junk' banks.What is of concern is the stability of the banking industry and the fear that there can be circumstances leading to bank runs.Therefore a case is made for some form of insurance -deposit insurance or lender of last-resort intervention- to prevent runs.Although a lender of last resort policy is not mentioned in the European Commission proposals,there are references to the deposit insurance systems created in European countries recently :

Country	Coverage (domestic currency)	Coverage (ECU)
Belgium (1985)	BEF 500000	11574
France (1979)	FF 400000	57970
Germany(1977)	30 % of equity	-
Netherlands (1972)	D.G. 35000	14957
Spain(1977)	pes 1500000	10585
United Kingdom (1979)	75% of deposits up to £ 20000	20833

Table Three : Deposit insurance systems in Europe
(Sources : Baltensperger-Dermine,1989 and Pecchioli,1987)

Three features of the European insurance systems make them unique.The first is that, contrary to the FDIC in America, they are totally ignored by the public.Publicity is even forbidden in Germany.The argument seems to be that the announcement of their creation could destabilize the confidence in the banking system.Since deposit insurance systems are unknown and since the coverage is small (incomplete in the UK),they are unlikely to contribute much to stability and one would have to rely on lender of last resort interventions of Central Banks to ensure

stability.Secondly, since the coverage is different across countries,it could be destabilising if depositors start to chase the best coverage.There is casual evidence that corporate treasurers diversify their deposits among several banks in accordance with the coverage of the deposit insurance systems.A third feature of European deposit insurance mechanisms is that they cover the deposits of domestic and foreign banks operating locally.This could create potential difficulties.Indeed,any insurance activity requires the monitoring of the risks taken by the insuree,but the principle of home country supervision would not allow the control of foreign entities by the domestic deposit insurance agency.A similar argument applies to lender of last resorts who,being primarily responsible for the stability of their domestic markets,might want to bail out both national banks and affiliates of foreign banks.In this case too,the monitoring of risks should be undertaken by the relevant lender of last resort.

Since European deposit insurance systems are not widely known by the public,it seems certain that they do not meet the objective of preventing runs on banks.One is left wondering about the motivation for their recent creation.European deposit insurance systems can be interpreted as a tool to create small risk free deposits while putting part of the cost of bailing out on the insurance fund funded by the banking industry.Being responsible in the end,the banking industry would act as a 'Banking Club' which would regulate its members (Goodhart,1985).These motivations are understandable but it

would seem that alternative institutional mechanisms can meet the same objectives : the creation of risk free banks would provide risk free deposits to those who wish to hold them and the financing by the banking sector of the cost of bailing out an institution can be enforced without recourse to a deposit insurance system.Recently in France for instance,the banking community was forced to finance the losses incurred by Al Saudi Banque.

It is our view that the current European proposals with domestic deposit insurance,home country control and mutual recognition provide adequate consumer protection,but that they do not meet the main issue of the stability of banking markets.Three ways can be used to achieve stability.The first is to adapt the current framework with its deposit insurance and lender of last resort facilities.A second approach suggests to rely exclusively on discretionary lender of last resort interventions, while the third suggests to abandon completely the safety net while adapting the contractual terms of the liquid deposits.

The current approach could be improved if the various deposit insurance systems would offer the same coverage and if domestic supervision would apply to all institutions,domestic or foreign, covered by the insurance or the lender of last resort safety nets.This imply the abandon of home country control as both deposit insurance and ,especially, lender of last resorts are essentially concerned with domestic losses, be they incurred by national banks or by the affiliates of foreign

banks.Moreover,these insurance sytems should be advertised.The major weakness with this system is that it reduces private incentives to monitor risks.It has been frequently suggested to rely on flexible insurance premiums, but so far, no one has succeeded in putting this proposal into practical use.

The second approach would be to abandon deposit insurance and to rely exclusively on the lender of last resort.As has been argued by Tobin(1987) and Goodfriend-King(1987),this is a function of the central bank that should be used extremely rarely.Indeed,there are strong presumptions that,in case of problems,deposits tend to flow to well managed banks so that one has not to fear massive runs.The major advantage of a discretionary safety net as opposed to a more systematic insurance is that it increases private incentives for monitoring and evaluating bank riskiness.As in the first proposal,the safety net is still in place and would be made available only to institutions financing illiquid assets with short term deposits .The cost of bailing out would be borne by the banking industry which would find it necessary to monitor its members.In this case too,as monetary authorities are likely to feel primarily responsible with the stability of their own domestic markets,they should be able to supervise all banks operating domestically.

The third approach already discussed in Baltensperger-Dermine (1987) is to attack the problem of bank runs at its root.Since it is the absence of cooperation among depositors and the hope to be the first to withdraw which causes the run,why not impose

the cost of bankruptcy 'ex post' on all current and former depositors.The incentives to run would be reduced since there would be no place to hide to avoid the losses.The two difficulties with this proposal are the definition of the time of failure and the enforcment of the 'ex post' penalty.The time of failure needs to be defined so that the penalty falls only on those who have withdrawn their funds after the failure.Enforcment of the penalty would require the means to identify depositors and the ability to tax them.A major difference between the 'ex post' penalty and a public safety net is that in the first case losses are borne by depositors while in the second case they are shifted to the public agency.The complete privatisation of costs is a clear advantage.

Recognising that ,under current legal systems,the enforcment of the 'ex post' penalty would be difficult,we would favor the second proposal ,a discretionary intervention system with a lender of last resort .The objective of financial stability is being met with this proposal while the private incentives for monitoring risk still remain since public intervention is uncertain. This proposal implies that ,as long as national monetary authorites are primarily responsible for the stability of their domestic market,they should keep full control on all banks opearting domestically.It is in the 'public interest' to keep such controls.

As it is well known that implicit guarantees on deposits reduce the private market incentives to monitor the risk taken

by banks and price it correctly into higher depsoit rates (the so-called moral hazard problem),there is the necessity for central banks to limit the size of their 'umbrella' and to introduce various types of regulation.This includes traditionally ratios on capital and liquidity plus large risk exposure.It involves also the specialisation of credit institutions and the separation between banking and commerce.If there is a directive harmonizing the control of own funds and a recommendation on large risks,this is not the case for the separation of banking,insurance and commerce.Each regulator can control the ownership of banks (the 'fit and proper' criteria) and the participations of banks in the non-financial sector.One must confess empirical ignorance as to the competitive edge that could be gained by conglomerate firms,but if it was to exist,it should be clear that least-regulated banks would be in a better position (Dermine,1989).It would seem useful to harmonize at least the links between banking and insurance .

Conclusions

We have argued that the 'home country control' and 'mutual recognition' principles are sound as far as the protection of depositors is concerned.However,when one turns to the major economic reason for public intervention,the stability of banking markets,the efficiency of these two principles is very much weaken .As long as national monetary authorities bear the responsibility for national and foreign banks operating

domestically, they should keep full supervisory controls on all institutions .There is a strong case for joint supervision by home and host country authorities.Deposit insurance systems in Europe do not appear necessary.The objective of protecting the 'small and uninformed' depositor can be achieved with the creation of risk free banks.If deposit insurance systems are being kept,their coverage must absolutely be harmonized.Finally,the need to limit the size of the 'umbrella' with constraints on the links between banking,insurance,commerce and industry, raises the need for further harmonization.As is being said on the other side of the Channel,the 'jury is still on'.

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