Home-host conflict

Despite structural attempts at supervisory co-ordination, international banking groups need to foster bilateral understanding with their subsidiaries' host regulators, argues ***David Rowe***

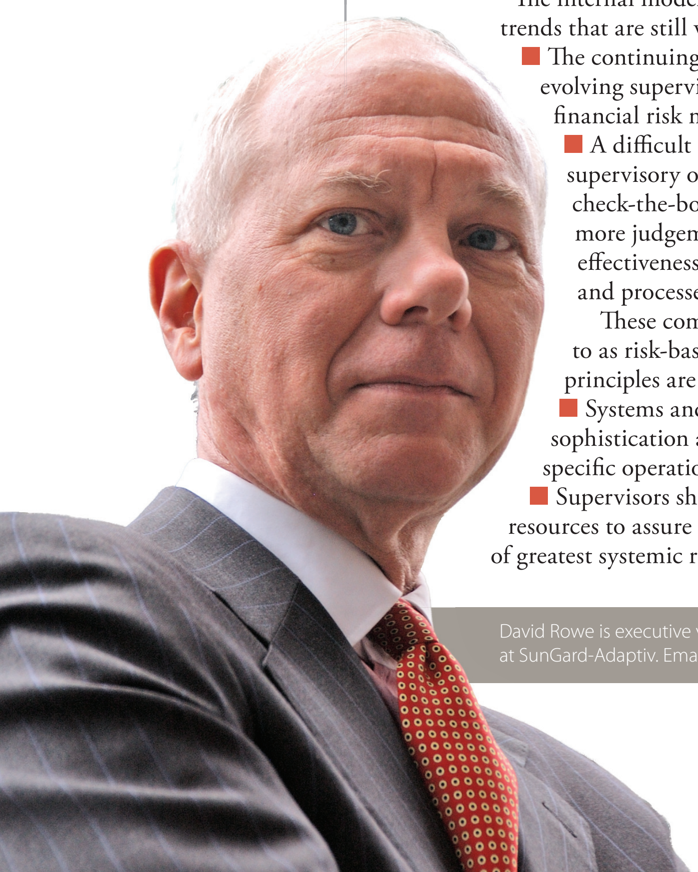
The challenges facing private financial institutions in complying with Basel II have been discussed for years. A closely related consideration is the difficult transition faced by banking supervisors. The allowed use of internal models to calculate minimum regulatory capital for market risk was a landmark event in the history of banking supervision. Like many banking risk practitioners at the time, I was delighted by this initiative, as it eliminated the need to maintain a separate regulatory calculation of questionable reliability in addition to a bank's far more sophisticated internal estimates of risk. While this may have resulted in some net reduction in total resources devoted to risk management, there was clearly a net addition to resources supporting the internal calculations of risk.

The internal models initiative produced two broad trends that are still very much with us today:

- The continuing demand for best practice as an evolving supervisory benchmark to which financial risk management is held accountable.
- A difficult cultural transition within supervisory organisations from a detailed check-the-boxes approach to compliance to a more judgemental assessment of the effectiveness of risk management systems and processes.

These combined trends are often referred to as risk-based supervision. The general principles are that:

- Systems and processes should be suitable in sophistication and scope to an institution's specific operations and the associated risks.
- Supervisors should allocate their limited resources to assure sufficient attention to the areas of greatest systemic risk.



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Basel II has further complicated this transition for both supervisors and financial institutions. On top of the existing need for supervisors to evaluate internal estimates of market risk, it introduces more detailed analysis of credit risk, plus the new and amorphous area of operational risk. This has aggravated the already serious difficulties supervisors face in attracting and holding qualified staff. While this is a common problem in the G-7 countries, such difficulties are especially severe in emerging market countries, including the 10 accession countries that joined the European Union on May 1, 2004.

Home-host complications

It has long been recognised that the increasing complexity of supervisory reviews and regulators' struggle to hold sophisticated staff present an especially serious burden for internationally active banks that operate in dozens of countries with different languages and cultures. To their credit, supervisors have initiated institutional efforts to co-ordinate and streamline the review of such groups' risk systems and procedures. The first initiative was the creation of the Basel Accord Implementation Group – essentially a voluntary co-ordination effort to simplify communication with the institution being reviewed. More recently – and more controversially – the European Union Capital Requirements Directive set up intra-EU supervisory groups where the home supervisor has more than a purely co-ordinating role. These groups are meant to reach decisions by consensus within a six-month deliberation period. If they cannot do so in specific instances, however, the home supervisor is empowered to make the decision.

Given the headaches in dealing with individual host supervisors on a bilateral basis, it is tempting for cross-border groups to rely on their home regulators to bring all host supervisors on board by persuasion if possible or by compulsion if necessary. In the face of such temptation, it would be wise to remember the sensitivity surrounding this issue. A group subsidiary will often have far greater relative importance to the host country than to the group as a whole. If such a group subsidiary encountered difficulty and local depositors suffered losses, there would be severe political consequences for the host supervisor. In addition, host supervisors have many ways to make an institution's life difficult. If host supervisors feel slighted by the consultation process, the local subsidiary of the cross-border group is likely to bear the consequences.

Supervisory co-operation is designed to relieve the excessive burden of forcing cross-border groups to negotiate system approvals with every host country. It would be unwise, however, to take such co-operation for granted. Friction among supervisors remains a fact of life, as does jealousy of local prerogatives. Global financial institutions will benefit by being as forthcoming as possible in briefing host supervisors on their general risk management practices and on any local modifications to meet special conditions in the host country. ■