The end of cross-border banking in emerging markets?
Adapting business models in the era of regulatory reform

17 May 2012, London

Conference Summary

Introductory Session

Speakers in the introductory session focussed on the turmoil in the global financial system and the magnitude of the challenges facing banks and regulators in both developed and emerging markets. The crisis was a severe shock to international financial integration and cross-border banking. Recent developments, in the form of wide-scale deleveraging by foreign banks, regulatory responses at the national level, and the growing “home bias” evident in parent banks’ consolidation strategies, signalled a trend towards a re-nationalisation of capital markets. Participants at the conference were challenged to reassess the existing model of cross-banking, the benefits but also the risks, and to consider how a coordinated policy response and regulatory framework could ensure its survival and stability in the long term.

While Emerging Europe has been hardest hit by deleveraging in recent months, this remains a global crisis and there is significant potential for emerging markets to share experiences and learn from different policy approaches. In contrast to most developed countries, emerging markets have considerable experience with banking crises and the difficulties associated with managing potentially destabilising capital flows. The current crisis is different in that it had its origins in developed markets, and is unique in its scale, scope, and the speed of contagion.

1 Individual presentations and speeches are made available on the EBRD website, where the presenters agreed to this disclosure. The discussion at the conference is however summarized without attributing remarks to specific participants. None of the views in this document or elsewhere on the conference website reflect the views of the EBRD, or of the G20 Secretariat.
Nevertheless, speakers emphasized the benefits from a common dialogue and regulatory reform at the multilateral level.

**Regulation developed for mature markets can have unintended consequences in emerging markets.** Regulators were quick to react to financial instability and deleveraging. In the words of one participant, the regulatory response (on the national and international level) had been “rapid and perhaps too comprehensive”. Ring-fencing and firewalls now pose serious challenges for multinational banking groups accustomed to managing liquidity across borders. The potential impact of higher capital requirements – including those expected under Basel III – on deleveraging, can be seen as one concrete example where the true consequences of regulation had not been fully anticipated. Each reform may seem sensible and efficient individually, though the combined effect of a large number of reforms may be impossible to assess ex ante.

| Session I. The record of cross-border banking in emerging markets: financial development and financial stability |

This session examined the empirical evidence on cross border banking. All three speakers were keen to emphasise that their research had substantiated important benefits for host countries. The presence of foreign banks stimulated firm growth by providing additional credit and alleviating the constraints inherent in relying on internal finance. Foreign banks help in overcoming informational obstacles and to some extent substitute for legal and institutional infrastructure in markets where this was poorly developed. In theory, the entry of foreign banks could have detrimental effects if they were to “cherry-pick”, leaving domestic banks with an inferior pool of borrowers and starving some sectors of the economy of credit. However, this does not appear to be substantiated by the evidence: foreign banks do not displace local ones and they have an important effect on the total supply of credit.

**A key benefit of foreign banks is the greater stability they provide in the context of a financial crisis within the home country.** While domestic banks are forced to cut back on lending, foreign bank subsidiaries, supported by strong parent banks, can continue to provide credit. In most regions, the presence of foreign banks therefore helps to off-set the impact of domestic banking crises on the real economy.

Yet, recent evidence shows that during the financial crisis, foreign banks also transmitted shocks in their balance sheets to host countries. This can be seen as a logical corollary of operating internal capital markets across borders, with subsidiaries forced to deleverage when the parent bank comes under pressure. By contrast, domestic banks were largely reliant on deposits, which constitute a more stable source of funding, and could thus continue lending during the crisis.
The speakers drew attention to the role of different funding models and their implications for financial stability. The literature on cross-border banking shows that dependence on foreign currency and wholesale funding make for a less stable credit supply than the use of local deposits. Different funding models appear to be preferred in different regions, raising the question of what determines the choice of model. In Latin America, for instance, foreign bank subsidiaries are far more reliant on local deposits than their European counterparts. This could be due to the nature and business models of the banks that operate in the region, but may also reflect the greater availability of local funding instruments in the region. In light of the dominant role that foreign banks play in emerging Europe, the viability of a more locally funded model could be an important determinant of future financial stability.

This heterogeneity needs to be taken into account when assessing the implications of regulatory reform. The discussion of the papers highlighted that regulation at the national level could cause banking groups to switch from a subsidiary to a branch model, since branches of foreign banks will be less subject to domestic regulation and supervision. Regulatory reform was seen as a balancing act, between limiting uncoordinated regulatory efforts by individual countries through a harmonised framework, and the need to preserve countries’ macro-prudential autonomy. There remains an underlying tension between three not wholly compatible objectives: banking efficiency, financial stability, and the need to contain bailouts at the costs of national taxpayers.

Session II. Evolving business models and capital market contexts

The second session examined bank business models in the context of local capital market contexts, as seen from the perspective of three important Western European parent banks operating in emerging markets.

- **The first business model stressed a focus on strategy and its execution**, as well as on client needs. This model is increasingly challenged by changes in the regulatory environment, such as increased protectionism, capital flow restrictions and increased supervision. There are also long-term challenges for international banks, such as scarcity of capital and funding and technological changes which might result in the disappearance of the role of intermediators. Un-coordinated regulation could prevent responding strategically to these risks.

- **A second model emphasised the importance of financial autonomy.** Based on local capitalisation and local funding financially independent subsidiaries will be subject to local supervision without reliance on cross-border funding. Short-run inefficiencies of this funding model were seen to be outweighed by the benefits of long-run stability. In particular, this model has helped prevent eurozone contagion spreading into subsidiaries. Strong operational integration
in order for retail banks to remain competitive, as well as a strong local presence as to achieve the necessary economies of scale, were further key success factors.

• The third bank presented a much stronger model of integration, in light of the heterogeneity of market across CEE where it operated, and their divergent implications for the operational model. Liquidity sub-pools were utilized in funding groups of subsidiaries. At present there is no uniform deleveraging trend. In particular, the diverging experience between reductions in Western banks’ exposure (in some countries by up to 50%) versus continued growth in countries such as Poland, Turkey and Serbia, was underlined.

Multinational companies need international banks which are able to provide the necessary skills and raise capital in multiple markets. International banks confront a number of threats, importantly from the rise of shadow-banking, and from the dis-intermediation that new technologies could bring. Whether international banking systems import instability depends on the funding model; subsidiaries with balance sheet management at the country level tend to be more resilient.

Uncoordinated local liquidity requirements were identified as a key threat to both bank efficiency and parent banks’ ability to operate an integrated treasury. Regulations could hence undermine a key beneficial role that parents can play, in particular in the CEE region.

Local capital markets that could enhance bank funding remain underdeveloped. Several speakers underlined that a sustainable funding environment through greater funding diversification, should be the key objective. Developing local capital markets will be a drawn out agenda that will require close coordination between supranational authorities (with funding capacity in these local markets), and with local authorities. In a world of largely independent subsidiaries there will need to be market access on a stand-alone basis, as has already happened (one parent bank highlighted that in several subsidiaries operating in such more liquid local markets, lending continued to grow strongly despite parent funding actually being cut).

No common view emerged as to whether branches or subsidiaries are more appropriate, nor whether there is a clear trend towards one or the other. One participant stressed that bank funding and the nature of business (consumer vs. wholesale banks), need to be considered. Subsidiarisation could help in the resolution of banks; however the branch model can be superior as a shock absorber within the host economy in allowing a more rapid move of capital between markets.
Session III. Financial stability and regulatory challenges from cross-border banking

The afternoon session was introduced with a speech from Andras Simor, Governor of the National Bank of Hungary.

The Governor highlighted the risk to CEE economies from a growing home bias among European financial institutions. Supervisors, likewise, may restrict banks’ foreign funding activities. Four factors shaping this pecking order are: (i) relative profitability, (ii) external financing needs, (iii) the degree of foreign currency lending, and (iv) the regulatory and tax environment. While parent banks’ home bias may be offset by higher profitability in host countries, high loan-to-deposit ratios, excessive FX mortgage lending and an unpredictable regulatory and tax regime could exacerbate the adverse effects of asset-side deleveraging.

The conclusions for an effective supervisory and regulatory architecture are:

- Coordination between regulators is essential, given cross-border bank groups’ presence in more than one jurisdiction which increases the potential for negative externalities of regulatory action. Importantly, coordination should be multilateral, not only bilateral, and needs to go beyond the home-host setting.
- Ring-fencing from home and host authorities may have detrimental effects, when common lenders exist.
- Provision and exchange of forward looking information is a key ingredient of coordination. Monitoring of EU bank deleveraging should be continued beyond June 2012 (the deadline for capitalization targets set by the European Banking Authority, EBA), possibly on a semi-annual basis.
- The Vienna Initiative 2.0 is a good starting point to address these issues in a multilateral setting, yet will have to tackle the problem of increased funding pressures.

The second intervention, by Usha Thorat of CEFRAL, offered a view of cross-border bank deleveraging and subsequent regulatory challenges through the lens of Asian markets, especially India. The crisis has also revealed a number of new linkages and regulatory trends:

- European bank deleveraging has so far been felt in India mostly through corporates’ reduced ability to borrow from international markets.
- The crisis will force a re-alignment of ownership shares, with stronger Asian banks expanding in emerging markets as European banks are constrained or may have to retrench.
- Despite the much lower extent of foreign bank presence when compared to emerging Europe, Asian emerging markets examine the issues of cross-border supervision and resolution equally closely. Recent central bank announcements point to a much greater proclivity to encourage subsidiarisation, given the greater clarity over local assets that could satisfy
local liabilities. During the boom phase up to 2008, vulnerability to credit flow reversals built up. As a result, more actively used macro-prudential measures, but also possibly some forms of capital controls, have become part of supervisors’ toolkits, though now some of these macro-prudential measures are no longer eligible for reciprocal recognition by home country supervisors.

Participants then split into groups to consider positions on three key issues in the regulation of cross-border banks in emerging markets. Below are the position notes from which key results were presented by the rapporteurs at the beginning of the concluding panel discussion. This reflected to the extent possible the views of the respective groups, although considerable divergences remained among participants.

**Group I:** Managing global deleveraging: policy priorities in emerging markets

**Group II:** Cross-border supervision: making colleges effective for emerging markets

**Group III:** Preparing for cross-border resolution and burden sharing arrangements

### Concluding Panel Discussion

The concluding panel drew on the results of the breakout groups, and reflected on the challenges in regulating international banks, within Europe but also in other emerging markets.

The experience in Latin America was highlighted as a reason for caution in the regulation of foreign banks. In Argentina, for instance, foreign-owned banks held relatively larger sovereign portfolios, had dollarised their portfolios more quickly and then engaged in capital flight with more ease; and eventually disengaged from the country more rapidly following the sovereign default.

At the same time, within Europe cross-border banks are integral to the fabric of the internal market. Given the dependence of the corporate sector on bank funds a further fragmentation of the EU market into separate national balance sheets bears grave risks. Few sources of growth remain within Europe and repairing the as yet inadequate institutional framework for the integrated financial market was a key point of discussion. One proposal could be to give more power to the EBA and to make it the lead supervisor for all the banks subjected to a stress test in order to have the same implementation of the single rulebook.

There were also grave concerns over the potentially disruptive effects of a sudden stop or reversal of capital flows for host countries. Supervisors should take into
account the perspective of the host country where the subsidiary is systemically important. Host countries may need additional protection through ex-ante burden-sharing mechanisms and ensuring that supervision based on a common rulebook is paramount.