• Older Literature (1980s up to GFC) showed generally beneficial effects for host country banking sectors on:
  • Competition and efficiency
  • Stability

• But more mixed results on access to financial services (credit) in host countries
But, results on competition/efficiency dependent on context

• Nonrandom selection
  • Most of the foreign banks were well-established and headquartered in developed countries

• Heterogeneity in effects
  • Greater in less developed host countries
  • Foreign banks were often at a competitive disadvantage in more developed banking sectors (Berger et al., 2000; De Young and Nolle, 1996; Peek, Rosengren, and Kasirye, 1999)
Stability

• Foreign banks help stabilize credit flows during host country banking crises
• But, can also transmit financial shocks from their home countries to host country banking sectors

Access

• Moving beyond cherry picking and serving home country clients abroad requires:
  • Better information environment (accounting standards, credit registries, collateral registries)
  • Strong framework for contract enforcement
In short, effects of foreign banks have always been heavily dependent on home/host context. Most recent studies focused on banking/real sector outcomes also underscore that conclusion.

• Post-liberalization gains in aggregate credit, growth and declines in growth volatility are greater if domestic banking sector was already competitive (Behn, Haselmann, Seru, and Vig, 2014)

• Foreign banks from developed economies especially dependent on strong legal frameworks to foster business formation (Alfaro, Beck, and Calomiris, 2015)
Post-GFC Trends likely to affect host country banking sectors

- Changes in the roster of foreign banks
  - Retrenchment by developed country banks (less than X-border, but notable)
  - Greater South-South entry; Regionalization

Alternative delivery mechanisms (fintech)
Outline of presentation

• Determinants of foreign bank entry

• Recent trends

• Effects of foreign bank presence on:
  • Competition/efficiency
  • Banking stability
  • Access to banking services
  *Through the lens of Post-GFC developments and trends*

• Emerging approaches to regulate and supervise international banks

• Policy recommendations
Determinants of foreign bank entry

• Foreign banks operate abroad in order to:
  • Follow home-country customers (Goldberg and Johnson, 1990; Focarelli and Pozzolo, 2000)
  • Pursue profitable opportunities abroad (Seth et al., 1998; Yamori, 1998)
  • Seek international portfolio diversification (Hayden et al., 2006; Garcia-Herrero and Vazquez, 2013)

• When doing so, the costs of information in the host economy are crucial
  • Foreign banks tend to locate in places with lower information costs for them (i.e., institutional/cultural/geographical proximity) (Buch, 2003; Van Horen, 2007; Claessens and Van Horen, 2014)
Additional factors

Foreign bank entry decisions may be distorted by:

- Regulatory arbitrage—foreign banks may take greater risk in less-regulated host economies (Acharya, 2003; Karolyi and Taboada, 2015; Dong, Song and Tao, 2011; Ongena, Popov and Udell, 2013)

- Restrictions that limit cross-border capital flows within a multinational bank group (i.e., macro prudential policies, countercyclical buffers, ring fencing)

- Financial safety nets in the host economy
Recent trends in foreign bank entry I

**PANEL A. NUMBER OF SUBSIDIARIES OF FOREIGN BANKS**

- High income
- Developing

**PANEL B. FOREIGN BANK CLOSURES**

- High income
- Developing
Recent trends in foreign bank entry II

PANEL C. FOREIGN ACQUISITIONS OF DOMESTIC BANKS

- High Income
- Developing

PANEL D. OWNERSHIP TRANSFERALS OF FOREIGN BANKS

- High income to Developing
- Developing to High income
Impact of foreign banks in a host economy

Efficiency & Competition    Financial Stability    Access to Credit
Efficiency and Competition

• In developing countries, foreign banks tend to be more efficient than local ones
  - Bonin et al., 2005; Demirguc-Kunt and Huizinga, 1999; Claessens et al., 2001
  - Foreign banks bring superior technologies, risk management systems, lower funding costs

• Evidence suggests that foreign banks tend to raise the efficiency of local banks
  - By forcing local banks to lower spreads and rationalize their costs (Clarke et al., 2003; Unite and Sullivan, 2001; Claessens et al., 2000)
  - Positive spillovers: local banks learn from foreign ones (Lehner and Schnitzer, 2008; Zhu, 2012; Jeon et al., 2011)
• In developing countries, foreign bank participation is positively associated with more competitive banking sectors (Clarke et al., 2003; Claessens et al., 2001)

• Competition is more intense when:
  • More efficient and less risky foreign banks enter markets with less concentrated banking sectors (Jeon et al., 2011)
  • Entry occurs through greenfield investment (Claeys and Hainz, 2014)
Risk-sharing through global banking has two sides

1. They can help smooth local shocks
   - Lower incidence of crises (Barth et al., 2004; Demirguc-Kunt et al., 1998)
   - More stable credit growth during local crises (Dages et al., 2000)
   - More diversified pool of liquidity, parent support

2. They may transfer shocks from abroad
   - 1998 Russian Crisis (Chava and Purnanandam, 2011; Schnabl, 2012)
   - Transmission of foreign monetary policy (Morais et al., 2015)
During the GFC, foreign banks contracted lending earlier and faster than domestic banks

- Contraction differed across bank characteristics
  - Less severe when foreign banks are large locally and rely more on local deposit-taking and less on wholesale funding (De Haas and Van Lelyveld, 2014)

- Regulation in host country mattered
  - More stability when banking sector regulation in host countries is more strict (Anginer et al., 2016)
Regionalization of foreign banks and South-South banking will bring both opportunities & risks for the financial stability of host economies

• Opportunities:
  • Easier coordination between home and host countries

• Risks & Challenges:
  • Shocks of home and host countries more correlated
  • Regulation in home countries of new foreign banks is more lax
Access to Credit - large heterogeneity across countries

• Impact of foreign banks on credit access greatly dependent on host country factors
  • Economic development, local banking sector development, informational and legal environment

• Among the least-developed countries, there can be a negative association between credit access and foreign bank entry
  • Foreign banks “cherry-pick” the largest firms, worsening the pool of borrowers of local banks (Detragiache et al., 2008)
  • Association found if foreign bank presence is small, if enforcing contracts is costly, and credit information is limited (Claessens and Van Horen, 2014)
Access to Credit and Investment Opportunities

*Foreign banks can expand credit access and investment opportunities:*

- By forcing local banks to go “down-market”
  - Local banks- advantage with informationally opaque clients (Beck and Martinez Peria, 2010; Beck and Brown, 2013; Mian, 2003-2005)

- By lending to underserved segments
  - Improvement of lending technologies based on hard information (Berger and Udell, 2006; De la Torre et al., 2010)

- By promoting trade and FDI (Claessens et al., 2014; Ongena et al., 2014)
Access to Credit- Regionalization and South-South banking

• Developing countries’ foreign banks more familiarized with host country’s environment
  • Perform better in weaker legal environments
  • Able to overcome challenges of lending to smaller clients (Mian, 2006; Claessens and van Horen, 2014)

• Business formation rates
  • More strongly correlated with developing countries’ foreign banks
  • However, developing countries’ banks more likely to finance industries with standardized inputs (Alfaro et al., 2015)
Performance of foreign banks by their country of headquarters

PANEL A. CREDIT GROWTH (%)

PANEL B. LOCAL DEPOSITS TO TOTAL LIABILITIES (%)
Performance of foreign banks by their country of headquarters II

PANEL C. INTEREST INCOME (%)

PANEL D. NON-PERFORMING LOANS (%)

Introduction  Determinants & Trends  Impact  Regulation & Supervision  Conclusions
Approaches for Regulation, Supervision and Resolution

• Having local authorities supervising international banks is suboptimal

• International Supervisory Coordination
  • Has been the preferred way to deal with this mismatch
  • Exchange information, harmonize regulations and supervision standards
  • Basel Committee (global standard-setter)

• Problems:
  • Coordination across countries is challenging and complex
  • Incentives of home and host authorities may not be aligned
    • When a foreign bank is systemic in the host country but not large in the home country, home country may have little interest in intervening
  • Regarding resolution, G-SIBs are extremely hard to resolve
Approaches for Regulation, Supervision and Resolution

- The GFC highlighted these problems
  - Coordination arrangements failed (non-binding)
  - Last minute and ad hoc interventions involving public support
  - “Banks are global in life and national in death” (Mervyn King, former Governor of the Bank of England)

- Since the GFC...
  - More restrictive regulation and monitoring of international banks
  - Preventive measures in case of distress (i.e., TLAC)
  - Regulatory barriers: macro prudential measures, countercyclical buffers, ring-fencing
Approaches for Regulation, Supervision and Resolution

- GFC revealed the need for a consistent framework for supervising and resolving globally active banks

- The financial trilemma (Schoenmaker, 2013)
  - Financial stability, financial integration and national financial policies are incompatible
  - Policymakers need to decide whether to be more financially integrated (i.e., the universal approach) or more financially sovereign (i.e., territorial approach)
  - Implementation of any of these approaches is complex

**Territorial approach**
- Non-cooperative approach
- Hinders benefits of foreign banks

**Intermediate approach**
- Elements of universal approach
- i.e., resolution procedures

**Universal approach**
- i.e., Banking Union
- Legally binding frameworks
- Central decision making

- More financial integration
- Less national sovereignty
Conclusions

• Foreign banks can improve local banking sectors, but benefits are more likely if the proper regulatory and supervisory frameworks are in place

• To reap benefits of foreign banks:
  • Financial liberalization accompanied by institutional reforms that improve information environment and contract enforcement
  • Diversified roster of home countries’ foreign banks (for stability and access)

• Regarding new generation of foreign banks:
  • Home countries with more lax regulation standards
  • Potentially hurt risk-smoothing (more correlated shocks)
  • May facilitate coordination among authorities
  • May be better to overcome challenges of lending “down-market”

• Fintech is rapidly changing the sector, bringing new challenges for regulation and supervision
Conclusions

• In terms of regulation/supervision/resolution:
  • Regulation, supervision and resolution of foreign banks is extremely complex

• Incentives across authorities to deal with G-SIBs are imperfect

• While the universal approach may be too extreme for most countries, some of its elements could be worth adopting
  • i.e., harmonizing procedures for resolution
  • i.e., having an ex-ante plan on how to share burdens in case of distress, rather than to improvise ex-post