Cross-Border Banking: Threat or Opportunity to Economic Growth and Financial Stability

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Abstract

Cross-border banking was not a major issue in economic growth and stability of the financial system until banks became large in size, began to engage in international transactions directly from their home countries and later by establishing or acquiring banks across their borders, and the level of international activities of banks intensified through complex products that increased exposure to systemic risk and possible losses to the economy. There is evidence on both sides to the argument that cross-border banking is both a threat and an opportunity to economic growth and financial stability. This paper argues what must be done to ensure that the opportunities outweigh the threats.

I. Introduction

Cross-border banking has its roots in the early years of banking, when the banks saw the need to expand the geographical scope of their services to unbanked areas and locations that host economic activities relating to their home bases. There was in the less developed countries then, the reference to banks in the 'metropolis' coming to the colonies to establish branch offices to mobilize deposits and finance the local purchases of raw materials and other inputs for manufacturing in their home countries.

Cross-border banking has its roots in the early years of banking, when the *geographical expansion* of the scope of banks' services to unbanked areas and locations that host economic activities connecting to their home bases was fashioned along the territorial exploits of the political class. It was, therefore, the pattern for a bank whose home country, for example, is the United Kingdom (UK) to establish a branch in Nigeria or Ghana, which was a colony of UK until they gained political independence. As such, sourcing of raw materials and other inputs for manufacturing activities in UK *needed local financing* that could not be done effectively from the home country.

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Indeed, this was a major motivation for the establishment of the African Banking Corporation in 1892 that metamorphosed in 1894 into what is known today as *First Bank of Nigeria Plc*. A similar argument goes for the colonial bank that was established in 1917 (acquired by Barclays Bank in 1925 and now *Union Bank of Nigeria Plc*). As time went on, banks began to pursue *business opportunities* outside the territories that their home countries had political dominion over. The rapid *economic integration* and *globalization* of the 20^{th} and early 21^{st} century made large business organizations and banks especially to seek for *growth* and *profit opportunities* outside their traditional markets.

Intensified globalization broke national/regional barriers and offered the opportunities for *efficiency improvement* and *performance enhancement* in banking services through cross-border competition. This came either in the form of *branches* or *subsidiaries* that banks established in their host countries. As the world economy evolved and regional groups and collaborations mushroomed, the strategy shifted from direct setting up of branches to *mergers and acquisitions* (M&A) of existing banks in target host countries, and raised a number of concerns about stability of the financial system, crisis preemption and resolution, along with several other issues in cross-border banking.

The extension of the frontiers of cross-border banking through M&A was particularly motivated by the regional banking system of regulation in the *European Union*. There is a long list of reasons why financial institutions engage in cross-border banking. Some of these are *quite obvious*, some have been identified in existing and burgeoning *literature* on cross-border banking, but some inferred from the *actual practice* and *behaviour* of cross-border banks.

This paper examines the reasons for cross-border banking, some stylized facts that link the growth and financial stability implications of cross-border banking, generates some recommendations for banking regulatory authorities and then draws some conclusions.

II. Why Cross-Border Banking?

Financial institutions engage in cross-border banking for various reasons including the following, among others:

i. Host countries' creditworthiness, which is measured in terms of sovereign risk and rating. The more credit worthy a country is, the more attractive it is for cross-border banks seeking growth opportunities outside their current jurisdictions.

ii. Quality of institutional environment, which is largely a reflection of what the government and financial system regulatory authorities have done over time. The stronger the institutional arrangement, the more attractive the target jurisdiction is.

iii. Easily identified growth opportunities, which obviously are not being maximized by the banks presently in operation.

iv. Regional or proximity bias, which reflects similarities in culture, regulation and banking practices that inspire confidence in the prospecting cross-border banks. This for example, is why banks operating in Nigeria have found it relatively attractive to cross borders within the West African sub-region.

v. Promise of scale economies, which follow the argument of 'bigger is better'. This relies on the assumption that bigger banks will have more opportunity to reduce their cost of doing business and reduce the cost of capital raising. There is also the argument that bigger banks are psychologically accepted as unlikely to fail, following the line of "Too Big To Fail", which attracts patronage in the thinking of 'flight to safety' by depositors.

vi. Risk diversification in which cross-border banks are able to spread or shift their risks across borders, and thereby reduce their vulnerability in the event that any of the large number of risks that banks are exposed to crystallizes.

vii. Liquidity enhancement, especially when the opportunity for deposit growth has become limited by the force of competition and there is perceived competitive advantage that the prospective cross-border bank can develop and/or utilize.

viii. Income expansion through asset creation where the credit market in the target country is expanding or it is still at the rudimentary stage. This of course, presupposes that the prospective cross-border bank has lending skills and capacity that match the characteristics of the target market.

ix. Trade financing and facilitation whenever the direction of trade statistics and future outlook recommend that the presence in existing locations would be complemented by establishing cross-border banks in the countries that are existing or emerging trade partners.

x. Regulatory arbitraging is another strong reason, although not so commonly established, why financial institutions engage in cross-border banking. Where there is perceived weak regulation in a jurisdiction relative to present countries of operation, banks might find it attractive to engage in cross-border banking. Weak regulation enables value creation through strange business opportunities, and could be of tremendous attraction.

The last of these reasons might appear untenable, but an examination of the *complexity* of many cross-border banks (in their structures, business lines and product delivery systems) suggest that this could be a strong argument for cross-border banking. The arguments that have been made in support of some of the other reasons are summarized as follows in some selected evidence-based research.

Capital flows and entry of foreign banks into a host country have been found to be functions of the quality of *countries' institutions*, *economic and financial openness*, *political stability* and *growth opportunities*. Eichengreen (2000) had an excellent review of capital flow determinants, while Clarke et al. (2003) gave a good review of foreign bank entry.

In particular, countries providing an environment with these attributes were found to have *attracted more* foreign banks than those lacking in these areas. This is quite similar to the findings of the series of annual reports on 'Doing Business' that emanate from the surveys conducted by the World Bank and International Finance Corporation. For banks seeking growth opportunities outside of their local markets, the motivation has been found to be *keen competition* and *limited local markets* that shrunk margins on transactions. In the process, they seek not mere migration to another jurisdiction, but to explore the benefits that size (through cross-border expansion) may confer on an internationally active bank, which situates branches as portfolio items.

Some institutions find attraction in exploring jurisdictions they perceive as *relatively low risk* and low level of sophistication. The thinking is that the systems and strategy of the cross-border banks should confer competitive advantage on them in their host countries, as banks that are already in operation in such markets are not as sophisticated as the cross-border banks.

Opportunities for liquidity enhancement through *net deposit mobilization* has also made cross-border banking attractive to some institutions, in an argument similar to that of domestic banks that decide to expand into any segment of the domestic banking market that promises such business opportunity. Some banking market segments offer predominantly deposit growth opportunities, some lending, others international trade, etc. Whether in the context of the 'hub-and-spoke' or 'modular' concept of branching, every branch finds strategic relevance in the corporate business portfolio, whether in the domestic or foreign banking market.

As well, there is the often undisclosed 'mission' of regulatory arbitraging by cross-border banks. They go with the perception that regulation in their host country is not as restrictive as in their home country, and therefore, they would have more *room for operational manouvres* that could confer profit advantage that is elusive in their home country. Such banks usually adopt very *complex structures* and *operations system* that are ostensibly designed to confuse or fool the regulators and other stakeholders in their host/home countries.

III. Stylized Facts

Quite logical arguments have been made in the literature and several evidence-based research into cross-border banking that underscore the relevance of such banks to economic growth, through encouraging competition that enhances *efficiency*. At the same time, cross-border banks have been proved to constitute a *formidable threat* to financial stability, and this is especially so in times of crisis.

Claessens (2006) listed *four modes* of cross-border banking as:

i. *Cross-border supply*, i.e., the traditional trade in goods and services, which in the context of finance means capital flows.
ii. *Consumption abroad*, e.g., obtaining some financial services while traveling.
iii. *Commercial presence*, i.e., the production of a good or service within the country, which means the foreign establishment in a host market.
iv. The *presence of persons* in the host country, e.g., solicitation of insurance products by agents traveling to the country.

The third mode is the primary reference in this paper. Structurally, cross-border banks organize as *head-office* vis-à-vis *branch* where the head office is in the home country and every other location is treated as a branch. Cross-border banks also operate through *subsidiaries*, the *parent* bank being in the home country while the subsidiaries can be involved in anything from banking to insurance and investment/asset management. Given their sheer size and the proportion they control of the banking market of their host countries, some cross-border banks can be quite *systemic*. This raises concerns about financial instability whenever there is a crisis.

The arguments have fallen into two planks of '*Too-Big-To-Fail*' (TBTF) and '*Too-Big-To-Rescue*' (TBTR). The former recognizes that failure of a cross-border bank can trigger contagion through its systemic risk and cause other banks in its host country to fail. The latter considers that the regulatory authorities of the host country might *lack the capacity* to rescue a failing or failed cross-border bank. There have been instances where the cross-border bank is *systemic in its host country*, whereas it is not in its home country. A few Nigerian banks have this attribute in the West African sub-region.

Mayes (2006) alluded to the Swedish *Nordea Banking Group* in this respect. As at March 2004, Nordea accounted for the following proportions of the banking market in *Finland* (**40.0 per cent**), *Denmark* (**25.0 per cent**), *Sweden* (**20.0 per cent**) and *Norway* (**15.0 per cent**), as well as the following in the insurance markets at *Finland* (**35.0 per cent**), *Denmark* (**20.0 per cent**), *Norway* (**9.0 per cent**) and *Sweden* (**6.0 per cent**). The failure of Nordea, therefore, could mean the collapse of the banking system and/or insurance market in any of these countries.

Cross-border banking has been argued to have *positive effects* on *efficiency* and *development*, *access* to financial services and promotes *stability*. This was succinctly put by Eisenbeis and Kaufman (2007) as follows.

> *"It is generally argued that foreign ownership of banks increases competition and efficiency in the banking sector of the host country, reduces risk exposures through greater geographical and industrial diversification, and enlarges the aggregate quantity of capital invested in the banking sector. Indeed, foreign entry through direct investment is widely recommended by researchers and analysts as a means of strengthening weak and inefficient banking structures, particularly in emerging economies. This is because banks that are willing and able to enter a foreign country, especially developing economies, through direct*

investments are generally larger, in healthier financial condition, more professionally managed, and more technically advanced than the average host country banks, and may therefore be expected to raise the bar for all banks.

Foreign ownership of banks *varies greatly among countries*. In Nigeria, there are only three banks (or 13 per cent) having dominant foreign shareholding, whereas in Sierra Leone, 77 per cent of the banks are foreign. In the European Union (EU), foreign ownership averages 58 per cent in the ten new EU member states as compared with a weighted average of 16 per cent for the older EU members.

Notwithstanding the benefits that might accrue to foreign ownership, cross-border banking through either branching or subsidiaries raises a number of *important policy issues*, especially when there is a threat of financial instability. These concerns have been argued as particularly important with respect to the provision of *deposit insurance*, the effectiveness of *prudential regulation*, the strength of *market discipline*, the timing of declaring an insolvent institution *officially insolvent* and placing it in *receivership*, and the procedures for resolving bank *insolvencies*.

For their empirical analysis though, Eisenbeis and Kaufman (2007) focused on the *European Union* because of its peculiarities large economic and financial system, with certain structures for and controls on cross-border banking:

A. Provision of a *single banking license*.
b. Home country as provider of *deposit insurance*.
c. Home country in charge of the application of the *bankruptcy processes*.
d. Host country responsible for *financial stability*.
e. Host country responsible for the *lender of last resort*.

Cross-border banks pose *regulatory challenges* in five possible situations they might find themselves:

i. In *normal times*, when the bank is compliant with regulations and performing competitively in the market.

ii. In *difficult times*, when, although the bank is compliant with regulations, it is underperforming in the market. This should ordinarily be sorted out by market discipline, which unfortunately might not be orderly.

iii. In times of *problems*, when the bank has become undercapitalized and the authorities require action if the bank is to remain in business.

iv. During *systemic events*, when although the bank is itself compliant with regulations, its viability is affected by outside shocks to the system.

v. In *actual or imminent default*, when the bank can no longer continue in normal operation and the authorities have to step in.

Eisenbeis and Kaufman (2007) further posited that:

> *"Cross-border banking through foreign-owned branches or subsidiaries can subject the entering institutions to multiple regulatory jurisdictions and regulators, as well as to many different legal systems. As a consequence, operating across borders presents potential problems for such banks beyond the fact that there are just more regulations to follow or regulators who may have different incentives. Bank laws can differ greatly and may even be conflicting across the different countries. Therefore, regulatory compliance may be uncertain and difficult for banking organizations with multiple country operations. Furthermore, bank supervisors and regulators in both home and host countries typically operate in what they consider is in the best interest of their country, however defined or perceived (Bollard, 2005)."*

These issues make cross-border banking quite a complicated matter, and yet they create a window for misbehaviour for organizations having the intention to break the rules. There is the conventional wisdom that cross-border (geographic) *mergers* have the potential to *reduce* bank (and thus regulators') *risk of insolvency*, following Segal (1974), Vander Vennet (1996) and Berger (2000). This rests on the notion that it is better for a bank not to put all its "eggs in one basket" and thus geographic diversification is a risk reducing activity.

However, offsetting these perceived benefits are at least two potential costs that may well enhance the risk of bank insolvency and ultimately the risk exposure of bank regulators. The first of these risk-increasing effects arises from the incentive of under-pricing of the regulatory "safety net" and its associated implicit and explicit guarantees. As discussed by John, John, and Senbet (1991) and John, Saunders, and Senbet (2000), banks have incentives to increase their *risk exposure* beyond the level that would be privately optimal in a world in which there were no safety net guarantees or the safety net (deposit insurance, capital requirements, and implicitly, bank closure) is fairly priced. This is the *moral hazard* angle to cross-border banking.

A second reason why cross-border acquisitions may increase an acquirer's risk concerns "who is watching the eggs in the basket", as argued by Winton (1999). Specifically, by extending its operations into new overseas markets, the (domestic) bank is confronted with potentially new and risk increasing monitoring problems related to the loan customer base, the operating cost structure, liquidity, etc, of the target bank. Amihud et. al. (2002) suggest that whether an acquirer's risk rises or falls as a result of a cross-border acquisition is highly idiosyncratic. They found that, on average, there is no evidence that cross-border merging banks add to the risk exposure of either domestic or host country regulators, whether looking at the total risk of the acquirer or its systematic risk relative to various banking industry indexes (home, host, world). These results hold for cross-border mergers in general and for various sub-samples of interregional cross-border mergers.

Buch et. al. (2005) used data for France, Germany, the U.K., and the U.S., and found that banks are likely to benefit from *diversifying risks* on their balance sheet by lending internationally through an improvement in the risk-return tradeoff due to the diversification of location (country)-specific risks. They went on to infer that the estimated gains from cross-border diversification appear considerable, but found a pattern of over-investment in the domestic economy of the reporting country.

The quality of information on cross-border banks that are available to the home and host regulators is a reflection of the size and structure of the banking system. Bauch et. al.(2005) present evidence for the U.S. that consolidation has led to a greater distance and thereby to *less lending* to more opaque SMEs, citing Berger, Miller, Petersen, Rajan and Stein (2005) as well as Carow, Kane and Marayaman (2004), Karceski, Ongena and Smith (2005), Sapienza (2002), Degryse and, Masschelein and Mitchell, (2005).

The fact that *too much competition* can undermine stability and lead to financial crises has been often argued (Allen and Gale, 2004), although difficult to document systematically (Beck, Dermirguc-Kunt and Levine, 2002). These complex relationships and tradeoffs among competition, financial system performance, access to financing, stability, and finally growth already make it clear that it is not sufficient to analyze a narrow concept of competitiveness alone.

The *information problems* are likely to become increasingly significant as banking organizations expand and consolidate many of their management and record keeping functions to achieve cost efficiencies. (Eisenbeis and Kaufman, 2007). Schüler (2003) argues that this problem of *information access* constitutes a form of agency problem between the home and host country regulator.

Following Ingves (2007), the major challenges (or threats) of cross-border banking include:

1. *Interdependence* that causes contagion.
2. Decisions by national authorities will have *implications* for foreign countries.
3. The *legal distinction* between branches and subsidiaries has become blurred.
4. Supervision and crisis management becomes *complicated* as more regulatory authorities get involved.
5. Conflicting national *interests*.

IV. Inferences and Recommendations

Based on these stylized facts from existing literature and the more recent experience of Nigerian banks that aggressively began to pursue cross-border banking, arguments have been made that *a Special body* should be created to supervise internationally active banks. Such considerations are, however, more popular with respect to Europe because that jurisdiction has witnessed a rapid increase in the number of cross-border banks through mergers and acquisitions in the last 25 years.

The desire to *regulate banking tightly* has also been tempered with the argument that regulation stifles competition, product development, efficiency and proper risk management. Achieving a balance between adequate regulation and encouraging (rather than stifling) commerce has been quite a challenge.

The recommendations of the Basel Working Committee (1996) on the supervision of cross-border banking are quite instructive for the Central Bank of Nigeria, working in collaboration with the regulatory authorities of countries into which Nigeria-licensed banks have expanded their operations. These recommendations are as follows:

i. Improve the *access of home supervisors* to information necessary for effective consolidated supervision.

ii. Improve the *access of host supervisors* to information necessary for effective host supervision.

iii. Ensure that all cross-border banking operations are *subject to effective* home and host supervision.

The report went on to indicate that access to information is the most critical of these three.

i. Ensuring that all cross-border banking operations are subject to effective home and host supervision.
   - Branch/subsidiary to home office.
   - Home office to home supervisor
   - Branch/subsidiary to host supervisor
   - Host supervisor to home supervisor

ii. Characteristics of the information required by home supervisors for ongoing supervision
   - Quantitative
   - Qualitative

Iv. Inspections by home country supervisors

v. Serious criminal activities

These were summarized differently by Eisenbeis and Kaufman (2007) as follows:

i. *Prompt legal closure* of institutions before they become economically insolvent.

ii. Prompt identification of *claims and assignment of losses*.

iii. Prompt *reopening of failed institutions*; and

iv. Prompt *recapitalizing* and *re-privatization* of failed institutions.

In the consultative document issued in September 2009 by the Basel Committee on Banking Supervision (for comments by 31st December 2009), the following recommendations emerged from an extensive review of literature and examination of four case studies of **Fortis** (substantial subsidiaries in Belgium, the Netherlands and Luxembourg), **Dexia** (Belgium, France and Luxembourg, quite significant in Luxembourg), **Kaupthing** (branches and subsidiaries in 13 jurisdictions) and **Lehman Brothers** (2,985 legal entities that operated in some 50 countries).

- Effective national *resolution powers*.
- Frameworks for a *coordinated resolution* of financial groups.
- *Convergence* of national resolution measures.
- *Cross-border effects* of national resolution measures.
- Reduction of *complexity* and *interconnectedness* of group structures and operations.
- *Planning in advance* for orderly resolution.
- Cross-border *cooperation* and information sharing.
- Strengthening risk *mitigation mechanisms*.
- Transfer of *contractual relationships*.
- Exit strategies and *market discipline*.

More specifically, the document highlights the *lessons* from each of the four case studies as follows:

Fortis

- The usefulness of formal supervisory crisis management tools appears to be limited in a situation where the institution needs to be stabilized rapidly and at the same time the continuity of business needs to be ensured in more than one jurisdiction.
- Tension between the need to maintain financial stability, for which a bank under certain circumstances needs to be resolved in the public interest and with public support, and the position of the shareholders of such a bank (i.e. dilution of their stake).
- Despite a long-standing relationship in ongoing supervision and information sharing, the Dutch and Belgian supervisory authorities assessed the situation differently. Differences in the assessment of available information and the sense of urgency complicated the resolution.

Dexia

- While the centralization of *liquidity management* within a cross-border group could lead to some tensions in case of liquidity problems, these tensions can be overcome by adequate cooperation between the relevant central banks.
- The cross-border nature of the group makes the *resolution process* more time consuming but this problem is not insurmountable in a case in which home and host

authorities clearly state their joint support to the group.

Kaupthing

- The Icelandic crisis revealed how limitations of *national resources* and, potentially, *supervisory capacity* can affect the ability to respond to a crisis involving financial institutions that had become "too big" for the home jurisdiction to provide effective consolidated supervision or to take necessary crisis management and resolution actions.
- Cross-border expansion can create its own risks of *unmanaged growth* in the absence of effective supervision by home authorities.
- Where a group is cross-border in nature with significant *intra-group claims* there is a need for effective and extensive cooperation and dialogue home to host, host to home and, depending on the circumstances, possibly also host to host.

Lehman Brothers

- If an acquirer for the entire firm can be found in an *appropriate timescale*, trading counterparties and other parties providing short-term funding will expect some sort of guarantee in the interim for them to continue to do business with the firm until the transaction closes this can be challenging to achieve in a tight timeframe.
- As the amounts of *liquidity needed* are likely to be sizable, governmental resources may be required.
- For international firms and groups of this degree of *complexity*, a prepared, orderly resolution plan would be of great assistance to the authorities;
- *Monitoring* by regulators and the interplay of insolvency regimes are important;
- Group *structures* create interdependencies within the organization that responsible regulators need to understand and monitor for both going concern and gone concern purposes;
- In the event of the failure of a cross-border financial institution, once the relevant *component entities* enter into insolvency proceedings, the insolvency regimes applicable to the major entities are likely to be separate proceedings, serving different policies, with different priorities and objectives; and
- These differences continue to make *coordination* and *cooperation* among insolvency

officials difficult as such coordination and cooperation may conflict with the duties of the officials to an entity's creditors. To do their job effectively, insolvency officials may need access to information and records that are part of an insolvency proceeding in another jurisdiction.

V. Conclusion

No doubt, there are growth opportunities in cross-border banking both for the banks themselves and the host economy. These arise from efficiency gains from increases in competition, reduction of risk exposures through geographical diversification and enlargement of the aggregate of capital invested in the banking sector.

All of these benefits will pale into insignificance in a crisis, wherein the costs of the crisis might offset the gains of cross-border banking. The costs are extenuated when there are deficiencies in supervision arising from:

1. Lack of cooperation and coordination by national and/or regional regulators.
2. Inhibited flow of information.
3. Selfishness resulting from regulator concern about only its national interests.
4. Weak market discipline.
5. Complex structures and interdependence of entities in the cross-border banks.

Perhaps the most important in all these is the structure, which if not well designed (through collaborations), the costs of insolvencies in cross-border banking are likely to be higher than necessary and make it counter-productive.

As such, cross-border banking can be a tremendous boost to economic growth where the right structures and collaborations with market disciplines exist and are maintained. It can also be a big burden, especially in times of financial crisis, and cause major upheavals that not only weaken confidence of participants in the financial markets but capable of dampening economic activities and throwing the economy into a deep recession or slump.

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