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DEVELOPMENT RESEARCH

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Bankers without Borders

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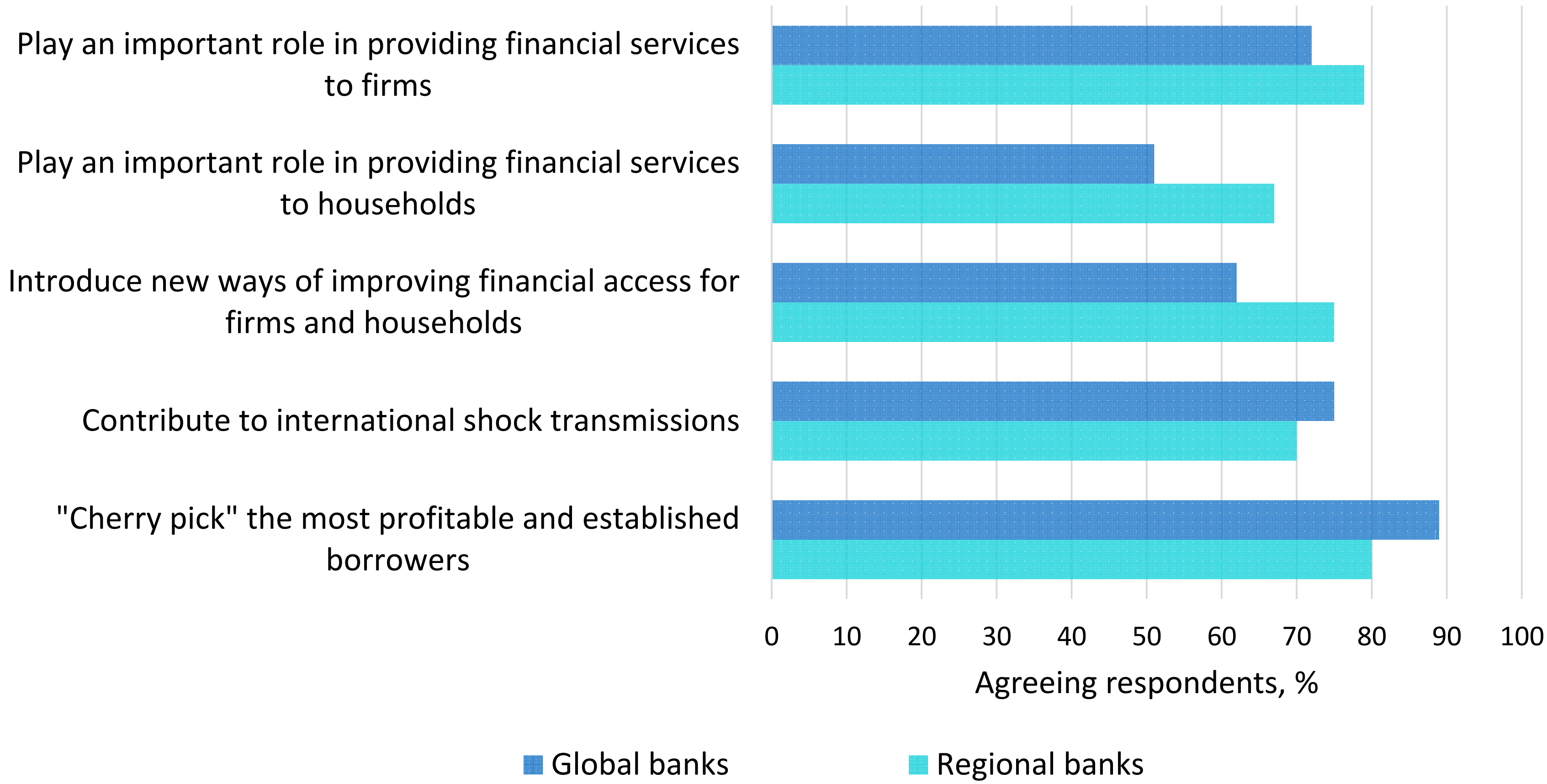
Why care about international banking?

- Global financial crisis led to a general backlash against globalization
- A re-evaluation of the pros and cons of international banks
  - Emphasis on shock transmission; impact of retrenchment of global banks
- Resulting in more stringent capital regulations, macroprudential rules
- And greater restrictions on foreign entry particularly by developing countries
- Concerns voiced by FSB, G-20 –about the effects of international banking, calling for policy measures and greater cooperation in resolving troubled international banks
- How does research to inform the policy debate?

Views from our clients – *Financial Development Barometer*

Impact of Global and Regional Banking



Important policy concerns

- To what extent should developing countries trust international banks with local provision of their financial services, given they may retrench?
- Should developing country authorities be especially cautious in their approach to admitting banking from other developing countries – "South-South international banking" ?
- Does allowing foreign banks to have a larger market share risk reducing access and increasing the price of banking services for small and medium enterprises (SMEs) and lower-income households?
- How is technology – fintech firms that work globally – likely to influence international banking?

What do we know so far?

International banks – definitions and activities

Definitions:

- An *international bank* is one with cross-border activities or foreign subsidiary or branches or both
- A *regional bank* is an international bank with operations in a specific region
- A *global bank* is an international bank with operations in multiple regions

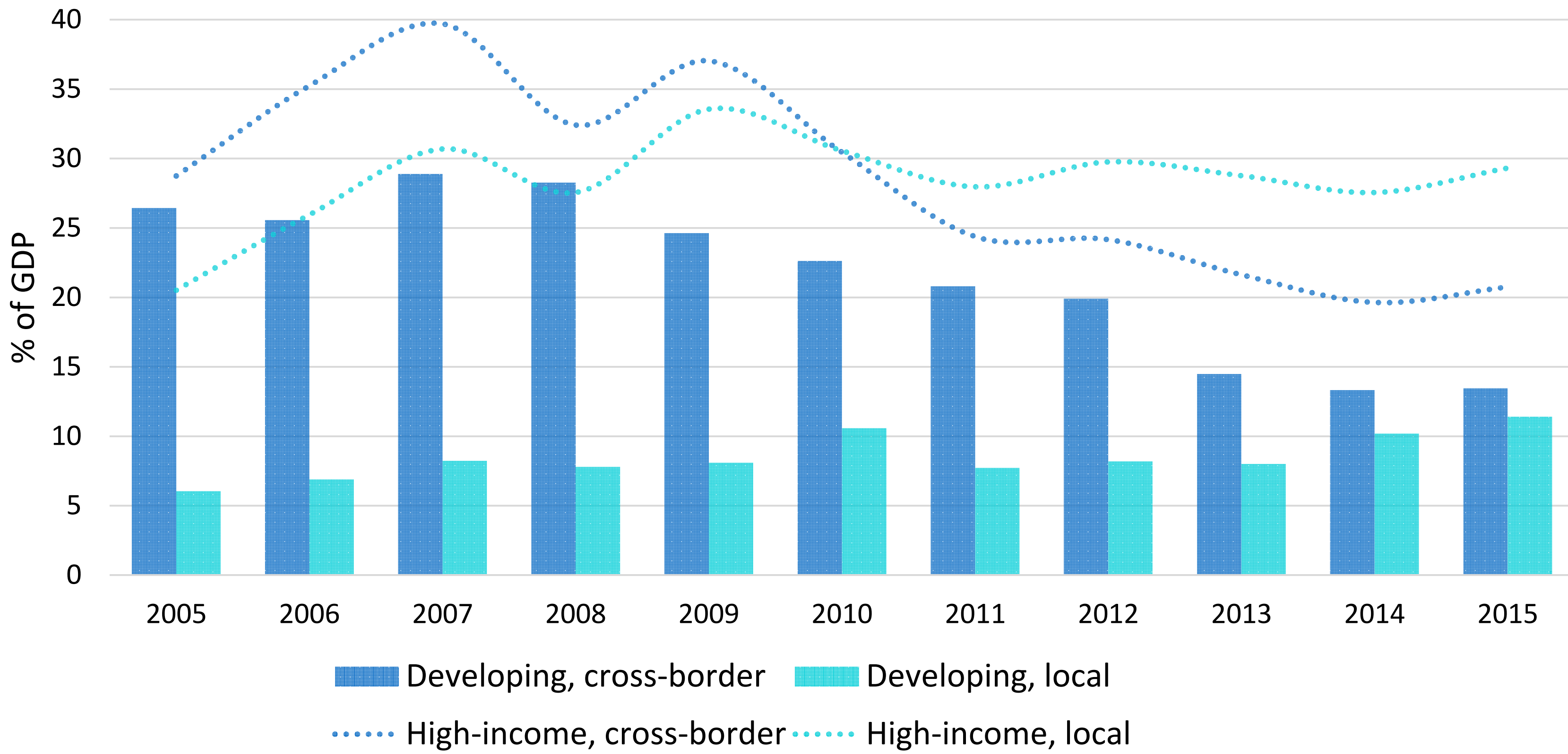
Two main activities of international banks:

- **Cross-border flows** – lending, deposit-taking or insurance operations in another country
- **Brick and mortar** – provision of these services through presence of a subsidiary or branch in another country

International banking – recent trends

- International banking suffered a set-back after the global financial crisis, but brick and mortar banking has proven to be more resilient

Cross-border and local claims by international banks, 2005–15

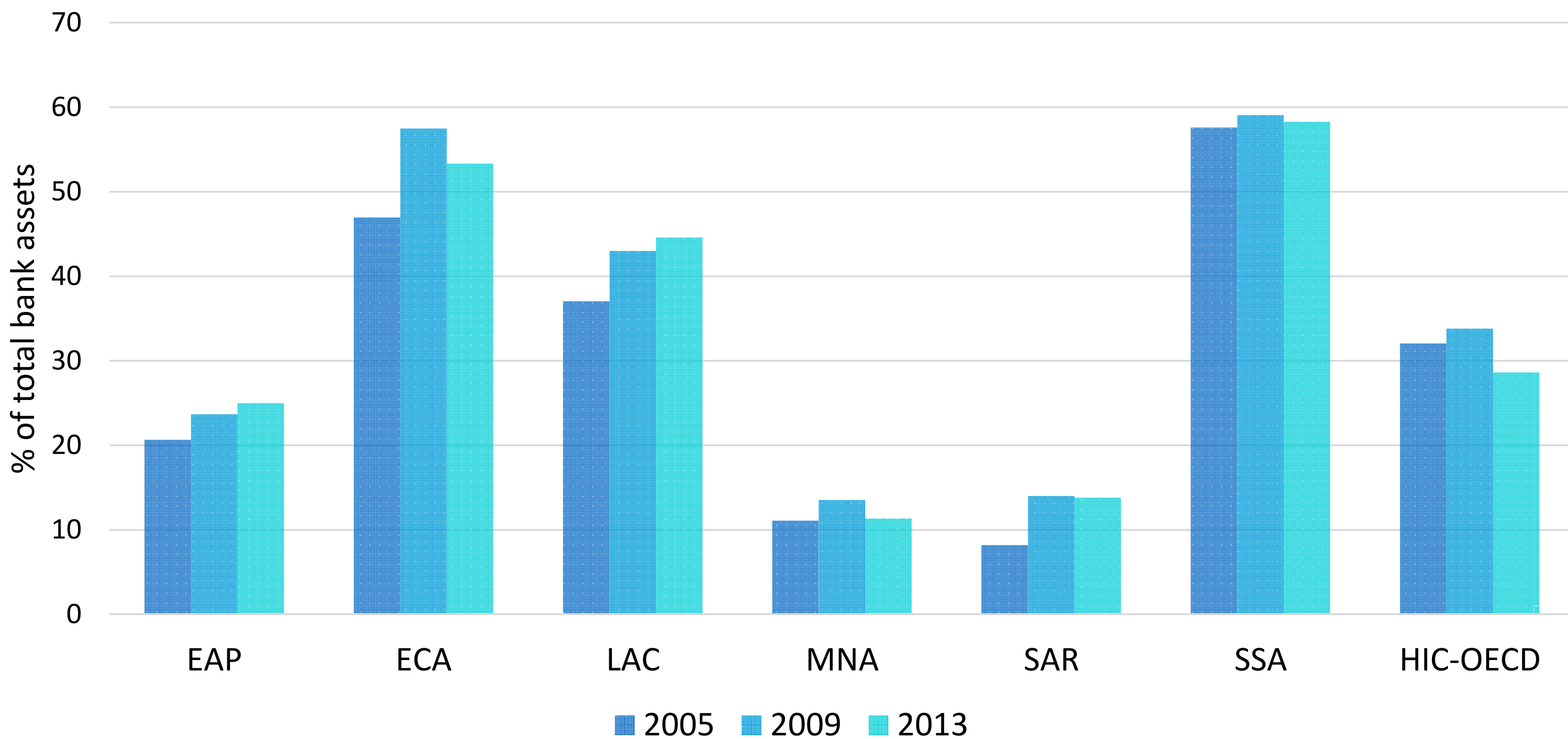


Source: Based on data from Bank for International Settlements.

International banking – still important in many regions

- Despite the setback, lending by international banks remains an important source of finance in many regions

Share of foreign bank assets, by region, 2005-2013

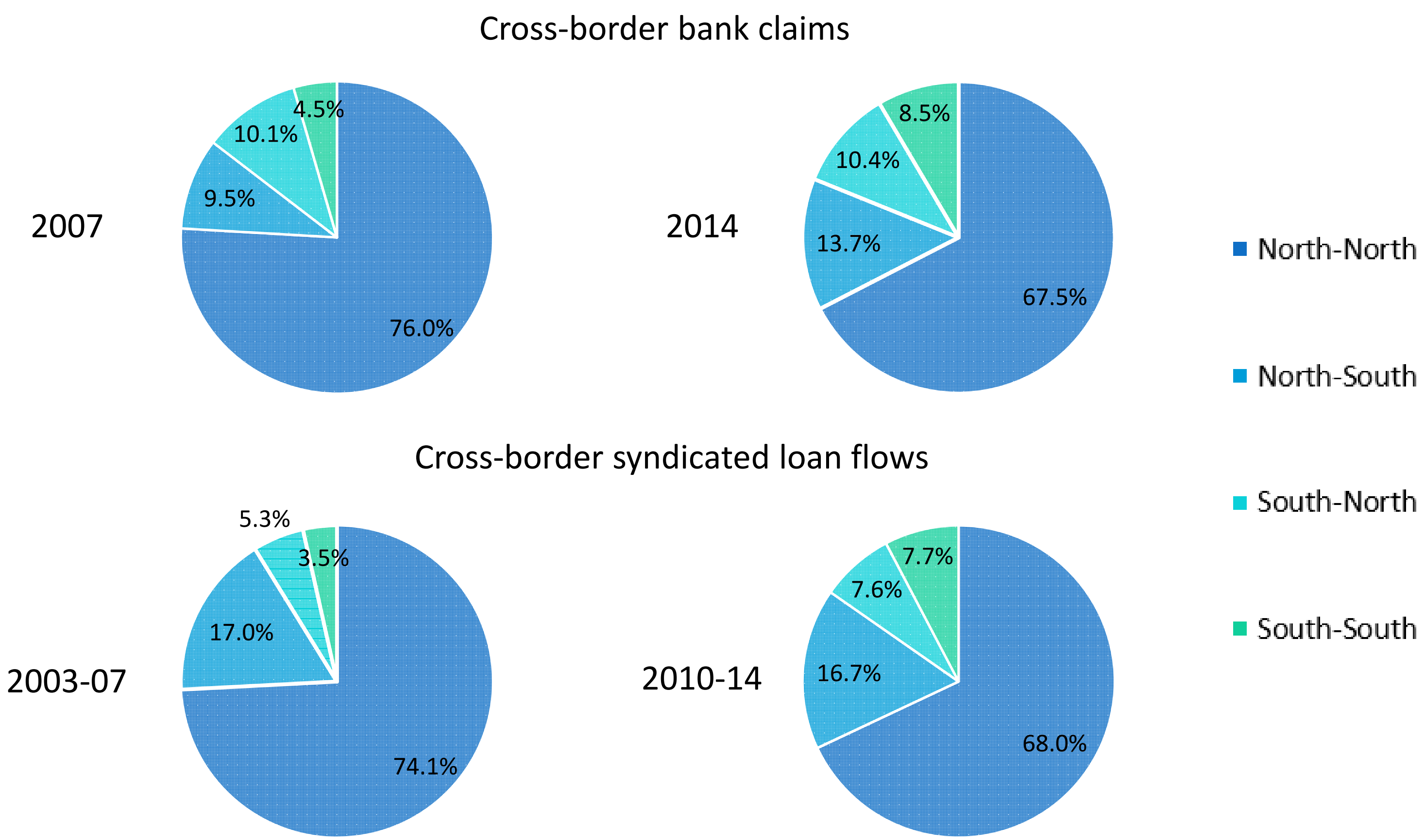


Source: Based on Foreign Bank Ownership database (Claessens and van Horen 2015).

South-South banking is on the rise…

- … both for cross-border bank activities…

Direction of cross-border bank lending, pre- and post- Global Financial Crisis

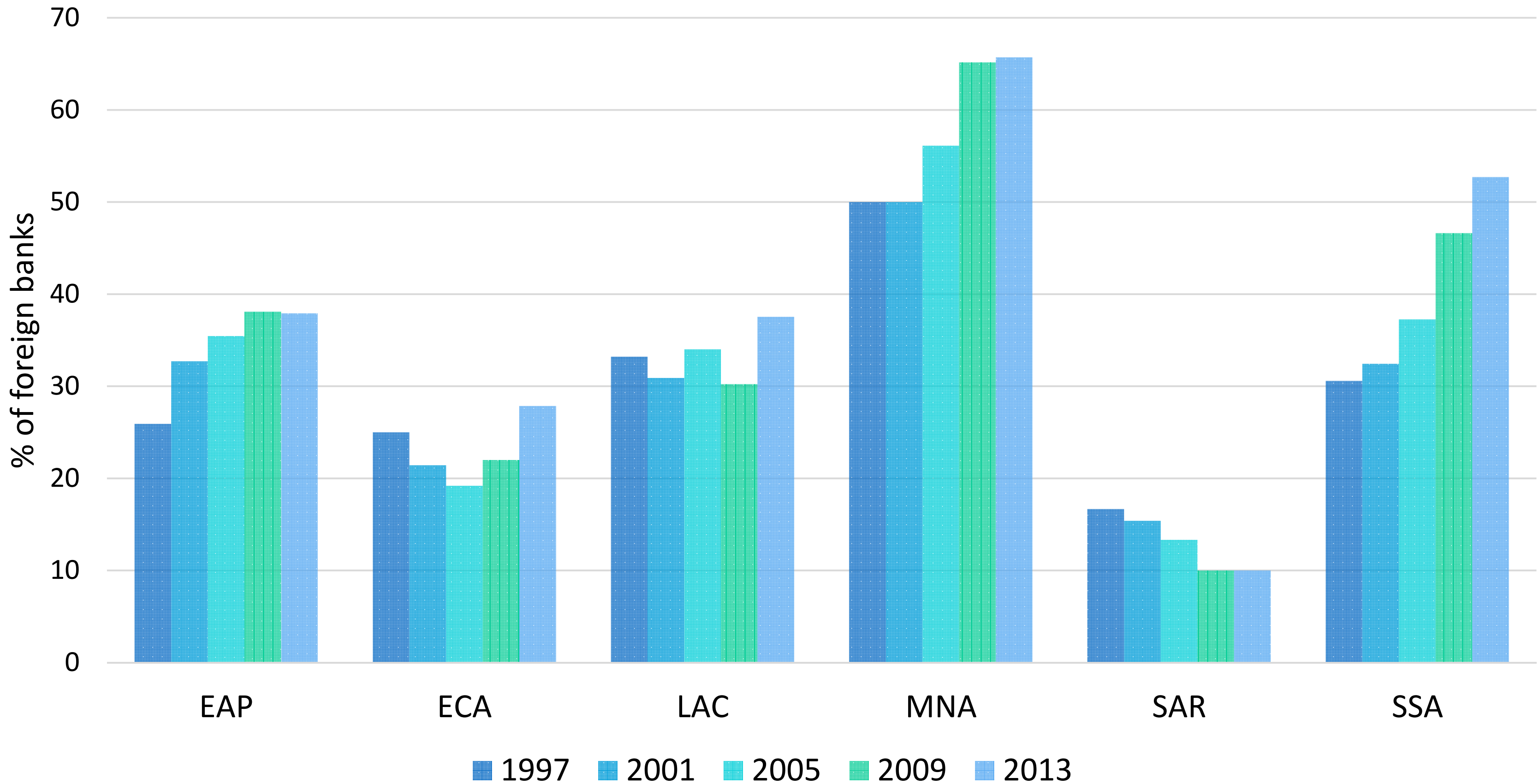


Source: Broner, Didier, Schmukler and von Peter 2017.

…and international banking is more regionalized

- …and for brick and mortar operations

Share of regional foreign banks among foreign banks, 1997-2013

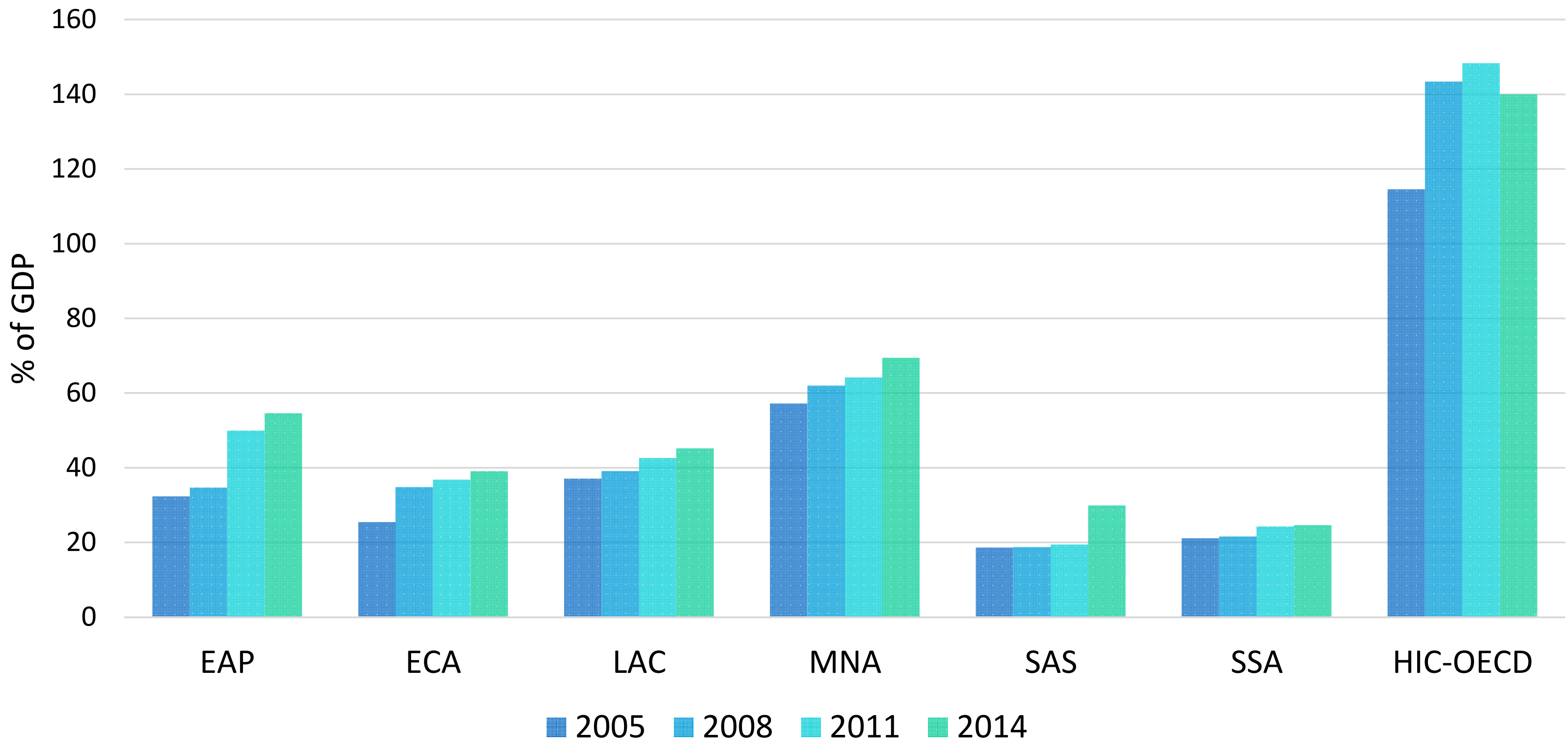


Source: Based on Foreign Bank Ownership Database (Claessens and van Horen 2015).

Bank size continued to increase

- The largest banks are also the ones that are active at the international level

Asset of top-5 banks to GDP, 2005-2014

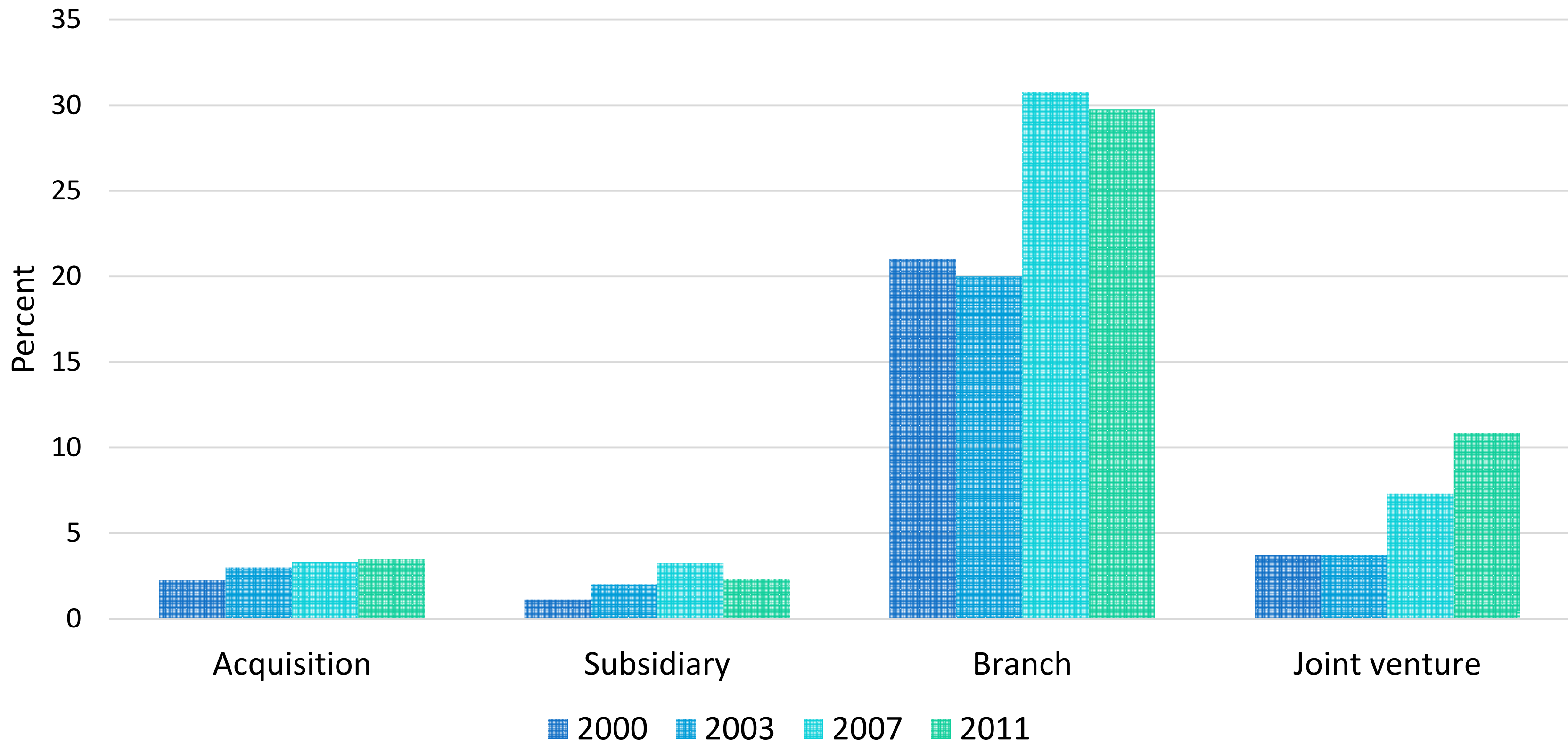


Source: Based on Bureau van Dijk Bankscope (database).

Since 2007, restrictions on foreign banking increased

- After the Global Financial Crisis, many developing countries adopted restrictive policies towards foreign banking

Share of developing countries with restrictions on foreign bank entry



Source: Based on World Bank Regulation and Supervision Database.

International banking comes with opportunities…

Benefits include a globally more efficient allocation of capital and enhanced risk-sharing leading to faster economic development and greater financial stability

- Liberalized capital account promotes external finance;
- increased competition due to foreign entry improves efficiency and domestic resource allocation;
- better know-how and financial skills are imported;
- pressures from foreign capital disciplines macro and financial management of countries;
- foreign entry may help improve regulation and supervision;
- break political entrenchment of domestic institutions and governments;
- risks can be exported and shared more efficiently

(Demirguc-Kunt, Evanoff, and Kaufman 2017; Cull, Martinez Peria, and Verrier 2017; Claessens 2016)

…and risks

However openness also comes with its own risks

- Exposing the countries to foreign risks, foreign monetary policy shocks (Morais and others 2015)
- Global finance may exacerbate boom-bust cycles (Borio and others 2011)
- Increased competition may reduce the franchise value of domestic banks, reduce access to finance and inclusion (Cull and others 2017)
- Risk-sharing inevitably implies that systemic shocks are imported (Peek and Rosengren 2000, Schnabl 2012)
- Internationalization expands risk-taking opportunities and may magnify the existing distortions – for example through design of safety nets (Demirguc-Kunt, Kane, and Laeven 2008, 2015)

Role of policy

Bank internationalization, on its own, is no panacea for guaranteeing financial development and stability

The challenge of policymakers is to provide an environment that will maximize the benefits from internationalization while minimizing the costs

Institutional environment is critical – better developed institutions help the countries reap both more of the development and risk-sharing benefits from international banking

- Poor information and contract enforcement => access benefits limited; added competition does not necessarily lead to expanded access for underserved segments – SMEs, households
- Lax regulation and supervision => credit flows may lead to excessive risk-taking, credit booms and crisis

Impact of international banking…

…is heterogenous and also depends on bank characteristics

Differences in origins, types and forms of flows and presence matter

- Larger foreign banks, greater local presence, greater cultural closeness, greater reliance on local deposit-taking and less on wholesale funding are associated with better development and stability outcomes
- Foreign subsidiaries – through their capitalization and local funding – may be more stable compared to branches
- Diversification of home countries and business models desirable in protecting against external shocks but may not be always possible

Demirguc-Kunt and others 2017; Cull and others 2017; Claessens and van Horen 2015

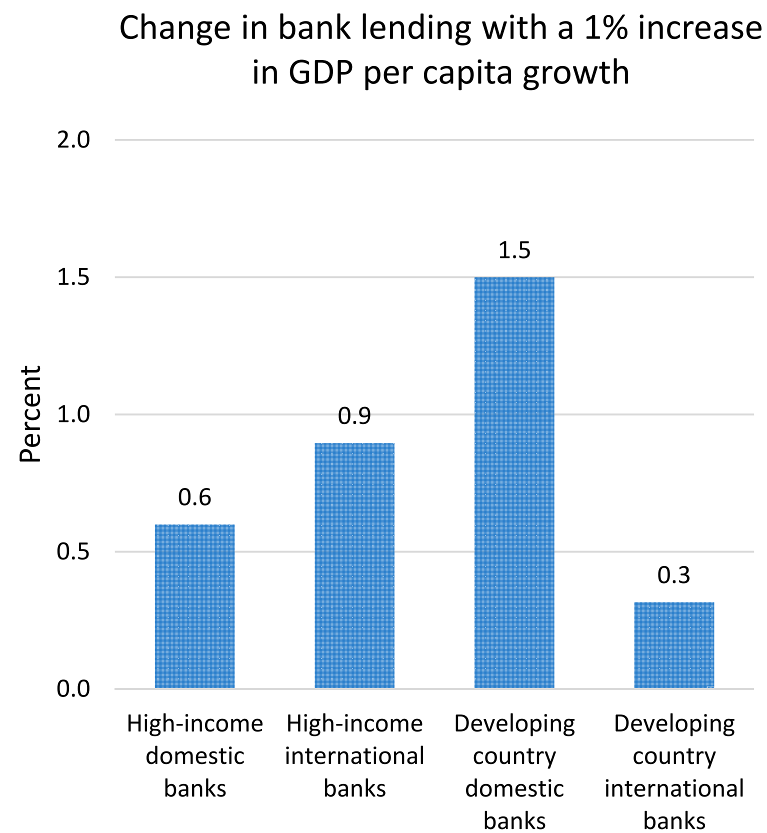
Three focus areas – new challenges

Three focus areas of importance in international banking represent new trends, limited research, opportunities and challenges for policymakers:

- The rise of South-South banking
- The shift towards alternative sources of funding
- The influence of technology – fintech – on international banking

The rise of South-South banking

- "South" banks are better at serving SMEs and HHs because they are used to working in informationally opaque environments
- Globally, bank lending is procyclical increasing during booms and falling during downturns. But in developing countries, the lending pattern of domestic banks is significantly more procyclical compared to international counterparts
- Bertay and others 2017 suggest international banks from the South have less procyclical lending patterns, which is more stabilizing

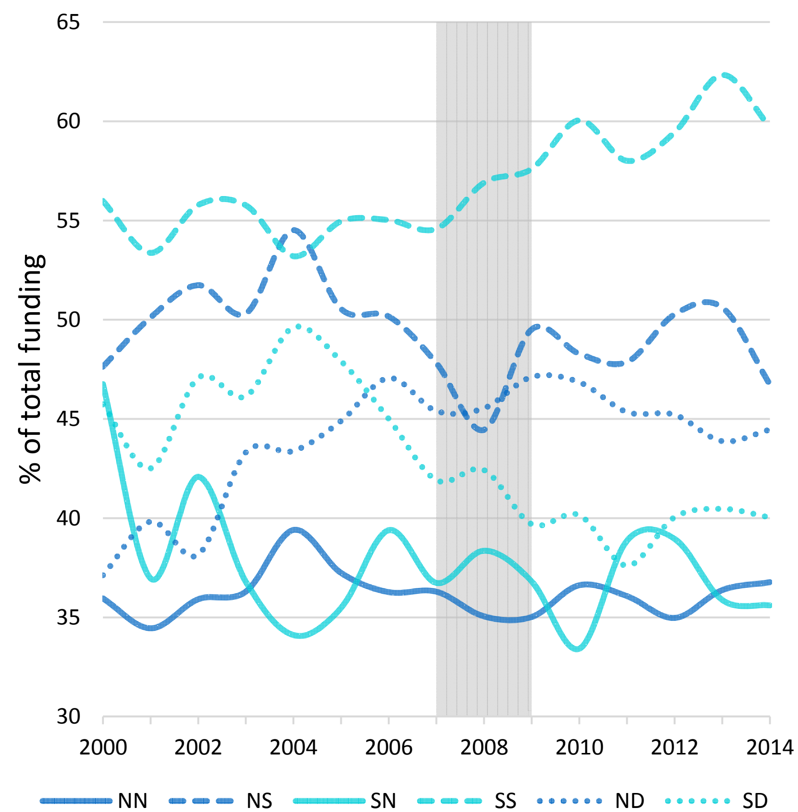


Source: Bertay, Demirguc-Kunt and Huizinga, 2017.
Analysis based on a sample of 2750 banks from 112 countries for the period 2000-2015.

The rise of South-South banking

- Funding of S-S subsidiaries also increasingly come from local customer deposits, which are also more stable
- However, regionalization in the South limits risk-sharing and implies a larger exposure of an economy to shocks within the region
- S-S banks may also bring increased risks stemming from more lax regulation in their home countries and could amplify credit booms in host countries (Claessens and van Horen 2016)

Contribution of local deposits to banks' total funding

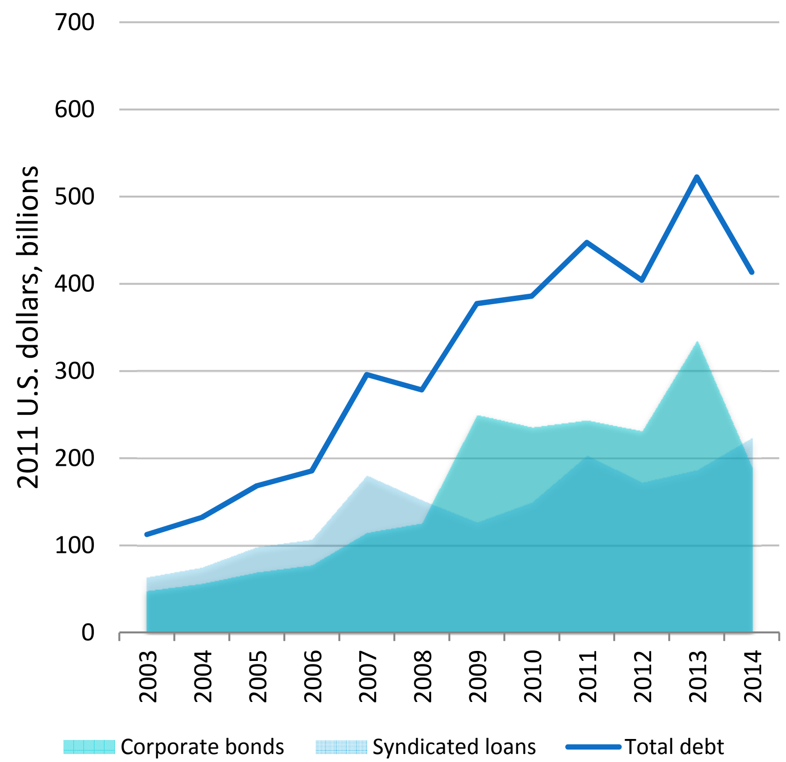


Source: Based on Bertay, Demirguc-Kunt and Huizinga 2017.

The shift towards alternative funding sources

- As GFC hit banking sectors, firms shifted to other funding sources
- Large firms in developing countries with access to capital markets moved toward bond markets (Cortina, Didier and Schmukler 2017)
- In developing countries, these firms also switched toward domestic banks and away from international banks
- Hence, decline in global financial activity was more limited than it would have been if it were not for these switches
- Highlights the importance of alternatives, but also the need to look at the financial system as a whole

Debt issuance composition – large firms in developing countries



Source: Cortina, Didier and Schmukler 2017.
Analysis based on a sample 262,351 debt security issuances by firms from 80 countries.

The shift towards alternative funding sources

- Domestic capital markets function as a "spare tire": firms listed on a stock market also saw a much more moderate decline in their leverage and use of long-term debt (Demirguc-Kunt, Martinez Peria and Tressel, 2017)

- But both studies also show that these shifts do not alleviate the funding constraints of smaller firms without access to markets:
  - Large international firms switching to domestic markets can crowd out smaller domestic issuers
  - Decline in LTD financing after the crisis was particularly pronounced among all non-listed firms, majority SMEs

- While alternatives need to be recognized, important role of banks for majority of firms in developing countries, remain.

Average change in capital structure by firm ownership type

Source: Demirguc-Kunt, Martinez Peria and Tressel 2017. Analysis based on a sample of 277,000 firms across 79 countries over the period 2004-2011.

The rise of fintech

- **Fintech** – tech-driven new companies providing financial services outside the traditional financial sector – very rapid growth
  - Is likely to re-shape competition in global finance; move from brick and mortar to non-physical channels; not limited to but particularly significant impact on increasing the speed and reducing cost of global payments and transfers, financial inclusion, impacting cross-border banking
  - Technology removes the need for third party to clear and settle payments; 90% of banks in US and UK are experimenting with blockchain applications
  - Risks include misuse of personal data, difficulties in identifying customers, electronic fraud, facilitating illicit transactions, need for consumer protection and lack of safety nets

The rise of fintech

- **Impact on Banks** – given scale effects of international banks and the highly regulated nature of the industry, there has been cooperation
  - Fintechs gain access to banks' scale and customers and banks can exploit fintech's expertise in programming and analyzing data
  - However the impact is likely to rise rapidly
- **Challenge:** regulating and monitoring the development of the industry
  - Excessive regulation would hinder potential
  - Global by nature, so regulation needs to be global too
  - Development of *regulatory sandboxes* - testing with low level of regulation for limited period in a controlled environment
  - Regtech – digitally enabled methods to address compliance requirements and monitoring of digital financial services

Main messages

- Remaining open to international finance is critical for developing countries to benefit from global flow of funds, knowledge, opportunity.

- Leading to greater competition, diversifying risks, international banks can promote growth and welfare

- However, international banking is no panacea; policies are important in maximizing benefits and minimizing costs

- Institutionally better developed countries reap both more of the development and risk-sharing benefits from international banking.
  - Good information sharing, property rights, contract enforcement and strong regulation and supervision are key