

Cross-Border Banking: Forces Driving Change and Resulting Regulatory Challenges

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I would like to welcome you to Chicago and thank the World Bank for cosponsoring this conference. Our partnerships with the World Bank, the International Monetary Fund, and the Bank for International Settlements have enabled us in recent years to discuss some very topical and timely issues affecting the international financial markets. We've been at this for nearly a decade now, and the conferences seem to get better and more policy relevant each year.

The topic for our current discussion is cross-border banking, and to initiate the discussion I'd like to address several basic questions in my opening remarks. First, why is cross-border banking suddenly such an important issue? What is driving the activity? Why do we need to be careful in the way that it progresses? What lessons can we draw from U.S. banking history? And finally, what are the relevant regulatory issues that we will hopefully begin to resolve over the next few days? While I won't cover all of these issues in detail, I will provide some general insights and hopefully set the stage for the discussion to follow.

First, why are we seeing such an increased push for cross-border banking? The answers are not all that surprising, and they align closely with the explanations for the recent consolidation of domestic banking sectors. The typical reason given for this expansion is financial liberation, or deregulation. Suddenly banks are not constrained and have the ability to expand beyond their previous borders. In the U.S., this evolved through a patchwork of state and federal laws and court decisions allowing states to give their banks the right to do business outside of their local areas. Over time there was a gradual relaxation of restrictions, allowing expansion first only at the local level, then to the state level. State legislators then agreed to

introduce regional compacts which allowed banks limited expansion across state lines. Years of fragmented, partial deregulation culminated in the passage of the Riegle–Neal Act of 1994, which eliminated almost all barriers to interstate banking in the U.S.

In the European Union (EU), cross-border banking evolved through a number of legislative acts, summarily referred to as the “Single Market Program.” The First Banking Coordination Directive, the Single European Act of 1986, and the Second Banking Directive of 1989 created a single banking market restricted only by constraints imposed by a bank’s home-country regulator. Since regulators did not want to place their own banks at a competitive disadvantage, the program essentially makes the EU a single market characterized by universal banks.

So deregulation is always given, and appropriately so, as a driving force behind geographic expansion in banking. But deregulation is endogenous. It doesn’t occur in a vacuum, but rather as a result of forces that caused the regulatory restrictions to increasingly bind firm behavior. In fact, these forces themselves are not independent of one another, but rather evolve as the others change.

Perhaps the single most important of these forces is technological change. Advances in technology have changed the bank production process, enabled banks to search out new markets, and provided new means by which they can service those markets. I think another factor affecting the progress of cross-border banking is a general realization by regulatory and legislative authorities that protected markets, and the associated market power created by that protection, is simply too costly for the local economies. There is a growing tendency to favor market mechanisms or regulatory liberalization to reap the associated efficiency gains. There is also a realization that the resource misallocation resulting from directed financing or state-controlled banks is simply too inefficient and costly to continue.

With these forces at work, the potential benefits from deregulation and the resulting cross-border activity are numerous. Economies of scale, economies of scope, and technical advances create efficiency gains that can then be passed on to consumers. A greater array of financial services becomes available, with better pricing, higher quality, and greater availability. Bank portfolios become more diverse, leading to decreased risk or a shift of the risk–return trade-off for banks. This diversification can lead to less volatile lending over the local business cycle, since the international presence allows banks to better withstand variability in local country business conditions over time. Credit allocation decisions improve and

credit becomes more available. Finally, new entrants into local markets bring in new risk management processes, new methods for delivering services, and new service offerings, creating demonstration effects that allow local firms to replicate them.

But does the research evidence indicate that any of these gains have been realized? While there is a wealth of research in these areas, I'll only highlight evidence concerning a few of the potential benefits.

Using quarterly data from Argentina and Mexico, Goldberg (2002) found that foreign banks exhibited lower loan volatility than domestic banks, resulting in more stability overall in the local credit markets. This is consistent with the position that foreign-owned banks have access to a more diversified, and therefore more stable, supply of funds. This can also result in an additional benefit as it serves as a countervailing force to the local business cycle.

Staff at the World Bank, using a sample of 80 countries, found that foreign bank entry reduced the profitability and improved the efficiency of domestic banks.¹ This is similar to the finding by staff here at the Chicago Fed, evaluating the impact of consolidation within the U.S., where local banks in the affected market respond aggressively to a new entrant by improving their technical efficiency.² For both studies, the findings are consistent with the expected beneficial response to a new competitive entrant.

But while the efficiency of other market participants has been shown to increase with a new entrant, there is less evidence concerning the efficiency gains for the parties involved in the merger. Studies using U.S. data have shown that, while mergers appear to have potential efficiency gains, since the acquiring firm is typically found to be more efficient than the acquired firm, these gains are frequently not realized. In fact, even using a more comprehensive measure of the impact of the merger, the stock price reaction, the findings are not consistent with gains being realized for the merging parties, as U.S. bank mergers are often met with a negative market reaction.³ However, a recent study by DeLong and DeYoung (2006) suggests that things may be changing. Using a "learning-by-observing" model, the authors argue that acquisitions of large complex banking organizations were a relatively new phenomenon in the U.S. when cross-state acquisitions were first allowed. During this period there were no best-practices to enable bank

¹See Claessens, Demirgüç-Kunt, and Huizinga (2000, 2001).

²See Evanoff and Örs (2005).

³See Evanoff and Örs (2005) for a summary of this literature.

managers to distinguish value-creating acquisitions. Through time, though, this has changed, and the authors find more recent mergers of large complex banking organizations to be value creating with a corresponding positive stock market reaction.

Similar changes may be occurring that could affect the attractiveness of cross-border acquisitions. Berger and DeYoung (2001) analyzed the extent to which parent bank companies were able to exert efficiency control over their affiliates as the distance between the head office and affiliate increases. They found that the parent exerted some control over the efficiency of the affiliate, although it dissipated with distance to the affiliate. A follow-up study,⁴ however, found that parental control over affiliates had increased over time, and the role of distance to the affiliate had declined. Thus, technological progress, and perhaps “learning-by-observing,” has facilitated geographic expansion in banking. Again, this could have implications for the viability of future cross-border banking activity.

So while there appear to be significant potential benefits from cross-border banking, there is also a realization that there may also be greater supervisory or regulatory problems associated with them, particularly during times of crisis. These potential problems increase as the role of the foreign-owned bank in the local domestic financial market increases, and there are numerous countries where the role of foreign banks in the industry structure is quite significant.

One major issue of concern is the role of the home- and host-country supervisory agencies and central banks. While the Basel Concordat lays out the framework for host/home-country cooperation, there may be times when their goals conflict and their interests diverge.⁵ The fear is that this divergence could be greater during crises.

At last year’s international conference, Alan Bollard, Governor of the Reserve Bank of New Zealand, spoke about why these conflicts can occur.⁶ This was particularly important to him given the dominant role of foreign banks in New Zealand. He argued that conflicts are most likely to arise:

- When home- and host-country authorities have different statutory objectives, such as depositor protection versus protection of the deposit insurance fund;

⁴See Berger and DeYoung (2001, 2006).

⁵For example, see Kane (2006) in this volume.

⁶See Bollard (2005).

- When in times of stress, the host authority requests that the parent bank inject additional capital into the bank subsidiary; the home country authority may typically be more concerned about the viability of the parent organization than the sub; and finally,
- When home and host authorities disagree about whether a crisis actually exists. What is considered a major crisis by the host authority may be viewed less seriously by the home-country authority.

In addition to these potential conflicts between home- and host-country authorities, there is an array of issues that could lead to additional complexities in addressing cross-border banking problems. How do the problems differ if the distressed bank is a branch versus an affiliate of a foreign bank? How and by whom are liquidity needs met? How should safety nets be structured? While the Basel Concordat emphasizes the importance of efficient information exchange between the home and host countries, it does little to lay out a framework for the coordination of intervention during a crisis. Should it? Or would this generate moral hazard and create additional costly distortions in private banking markets? Are there payments system issues associated with the increased cross-border activity? Will the increased activity help solve or exacerbate multicurrency settlement concerns? Finally, how will the eventual introduction of Basel II affect the supervision and regulation of active cross-border banks? These are the relevant questions going forward, and I'm sure we'll hear much about these and related issues during this conference.

I should emphasize that attempts to stifle this natural cross-border evolution can generate significant banking and financial market distortions. One only needs to look at the U.S. markets to see the evidence. Due to geographic regulation that precluded or significantly limited new entry into banking markets, the U.S. has one of the most unique industry structures in the world, with more banks, banks per capita, and banks per area than any other country. When we began relaxing the cross-state restrictions, we did it via the regional compacts that I mentioned earlier. As a result, we had money centers developing in areas that would not typically be thought to be prime candidates as financial giants. However, consolidation was allowed to occur in these areas, and it generated a rather unique and unexpected industry structure.

A final example of attempting to stifle natural industry evolution concerns the State of Illinois, which always had rather restrictive geographic expansion laws and waited years before allowing cross-state acquisitions.

In fact, when Continental Illinois Bank got into financial difficulties in the 1980s, the state legislature passed a bill that would have allowed a bank from outside of Illinois to acquire Illinois banks with certain characteristics. Those characteristics described Continental Illinois, and only Continental Illinois. It was an attempt by the legislature to continue to protect local markets, while at the same time realizing the realities of the marketplace.

Again, the goal was to keep “foreign”-owned banks out of the state. But the evolution of banking markets continued, and when industry consolidation did occur, Chicago’s larger banks were more apt to be acquisition targets instead of acquirers. As a result, today there are very few money center banks headquartered in Chicago.⁷ My point is that the evolution of banking markets is going to continue. Attempts to choose a local champion and artificially slow that natural evolution process will only serve to generate market distortions and inefficiencies for customers in those protected markets. And it will change the starting point for the inevitable industry consolidation. As regulators and supervisors, we need to figure out how best to address the safety net concerns and resolution processes and move forward. I’m interested in hearing your views during this conference on precisely how that can best be done.

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