Multinational vs International Banks

Here it is important to distinguish between the cross-border transactions among non-associated banks and cross-border transactions that are internal to global banking groups.[17] Within the general category of global banking groups, McCauley et al (2010) further distinguish between "multinational" banks (collection of affiliates, each mostly relying on local funding) and "international" banks (institutions in which decisions are centrally taken by HQ, with funding pooled from each source and then redistributed from the center). Each type raises a distinct set of policy issues.

The polar case of a "multinational" bank is when an institution operates as a collection of country affiliates, each with purely local funding and purely local assets. While there are no cross-border credit flows, the fortunes of the country affiliates are still tied together by the global profitability and capital of the parent, since this will influence its strategic decisions about country-by-country capital levels and lending policies. The value of the global banking group depends on the profits/losses of each affiliate. Thus even a multi-national bank can transmit shocks between countries. Arguably, such shocks could be smoothed out by the center, and any consequences will be felt only with a lag insofar as they are transmitted through changes in affiliate capital.

In contrast, the international bank could transmit shocks more directly and quickly through changes in its affiliates' funding.

Subsidiarization and Funding

In both cases but especially the "international" bank model, an important organizational choice is whether to structure country affiliates as branches or subsidiaries. Subsidiaries are fully incorporated entities in the host country and must meet the host country standards for capital adequacy and other regulations. They have their own capital requirements and limits on the relationships with the parent bank, including assets and liability transfers, local boards of directors, and so on. Such "ring-fencing" should make it easier for the host country to implement an effective macro-prudential framework while also making cross-border resolution easier in case of a crisis.[18]

A related but distinct dimension is the funding model. The local operations of the foreign bank can be funded mainly from local deposits, or they may rely substantially on wholesale funding from the parent bank or wholesale market. When lending expands faster than core deposits, those deposits tend to migrate to non-core-funding reliant banks, as we have seen. If foreign-owned banks rely on short-term wholesale funding for a substantial share of their lending, procyclicality will be built into their balance sheet management regardless of whether they are branches or subsidiaries.

Foreign-owned banks in Central and Eastern Europe had the legal form of subsidiaries, to take a prominent case in point. While these banks raised considerable local funding, a further source of cross-border credit was inter-office funding channeled by Western European parents through their subsidiaries. In this way, the operations of foreign-owned banks permitted a faster rate of credit growth than would have been possible otherwise. In turn, this also set the stage for a potentially costlier contraction. The decision by a major foreign bank to contract lending in the host country (for instance, in response to regulatory pressures in

[17] See Cetorelli and Goldberg (2010, 2011) and Claessens and van Horen (2012).

[18] That said, host-country regulation of subsidiaries might not be sufficient. Ranciere et al. (2010) show that foreign-owned banks evaded host-country controls on lending volumes by switching some lending from the local affiliate to direct lending by the parent bank, where these direct loans were brokered by the local affiliate.