

## FINANCIAL SYSTEMS AND REGULATION

# The globalisation of banking: How is regulation affecting global banks?

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## The globalisation of banking: development over time and geographically

The presence of foreign banks internationally, which had increased considerably up until the financial crisis, levelled off and even declined slightly after 2009. Even so, the financial systems of some regions (Central and Eastern Europe, Latin America, and certain parts of Africa) continue to show high percentages of foreign banks. Furthermore, international banking flows have diminished overall, but unevenly from one region to another. Nonetheless, according to the literature, the reduction in lending has been less obvious in subsidiaries and branches of banks that mainly fund themselves by means of local deposits.

## Internationalisation strategies and their determinants

Expansion has taken place in two basic forms: 1) cross-border lending from the home country, and 2) establishing physical branches and/or subsidiaries. In the latter case, opting for one or the other or a combination of both is determined by factors such as: (i) regulations; (ii) business strategy and penetration in the host country; (iii) tax on profits; (iv) country risk and (v) the development of new technologies and their effect on institutions' physical presence. However, the choice between branch and subsidiary is no trifling matter, and in practice bank structures are complex, combining both branches and subsidiaries.

## Effect of regulation on global banks' withdrawal

In the past few years there has been a tendency for global banks to abandon certain countries and business lines. The reasons given are many and varied: efficiency and profitability, institutional changes, organisational simplicity, etc. But above all, regulation. Aspects such as stricter capital and liquidity requirements, the new resolution framework, the segregation of activities or ring-fencing and the differing levels and speeds of countries' regulatory reform implementation are leading global banks to revisit the question as to whether the organisational structure they are working with is the best one and whether it is worth their while being in certain geographical regions and business areas.

## Recent evidence of global banks' withdrawal

An analysis of banks from the US, Canada, UK, Sweden, Germany, Austria, the Netherlands, France, Italy, Spain and China highlights the influence of regulation on banks' international presence. Four salient features are: (i) More than half of these banks cite regulation as the reason for pulling out of certain countries; (ii) Banks that received state assistance in the crisis are by no means the only ones withdrawing; (iii) While in Europe we see a slight tendency towards "branchification", in Latin America it is more usual to operate through subsidiaries and in Asia-Pacific through branches and (iv) Restructuring has affected investment banking most, especially in Europe.

## Challenges: greater regulatory uniformity and impartiality towards business models

At present, and even more so in the next few years, regulatory harmonisation on a worldwide scale is crucial if we are to avoid financial institutions having comparative advantages depending on their country of origin and in order to ensure freedom of establishment without one business model being favoured over another, irrespective of banks' organisational structure.

## 1. The globalisation of banking

Since the 1990s, the globalisation of financial services has been driven by factors such as technology, deregulation and increasing financial integration among countries. Banks have expanded internationally for four basic reasons: (i) *In search of business opportunities and risk diversification* (Wildman, 2010, Claessens et al, 2014a); (ii) *To improve efficiency* in the use of capital by obtaining economies of scale (Tröger, 2012); (iii) Incentives in *countries with transparent and relatively non-interventionist institutional and regulatory frameworks* (Claessens et al, 2008); and (iv) *To accompany corporate clients* in their international expansion (Buch, 2005), which they usually do in countries that are geographically close and with cultural features in common.

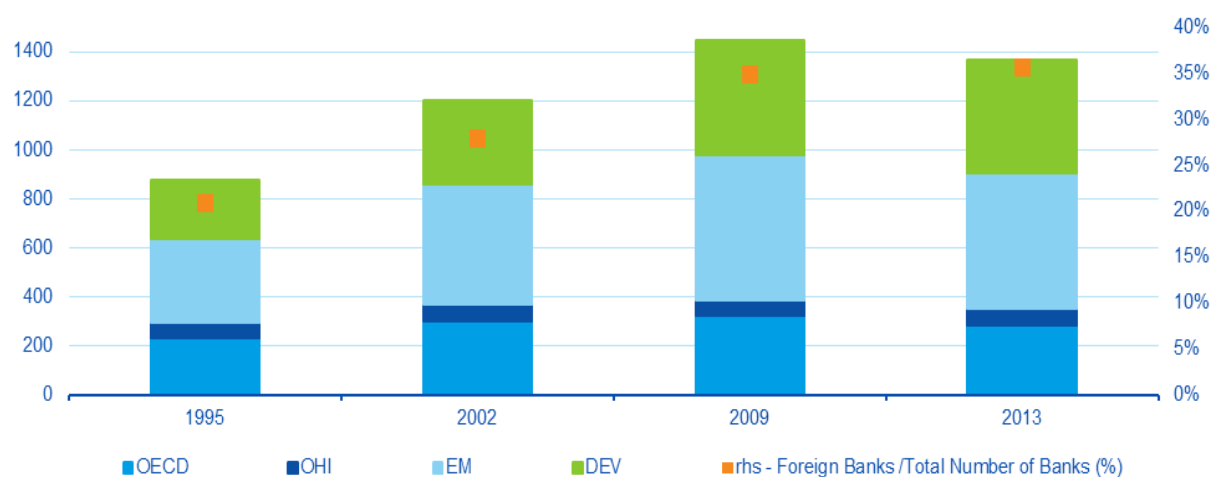
This document deals firstly with the broader aspects of the process, such as its development over time and geographically and its implications for the host country's banking system. Secondly we look at the legal structures chosen by banks in this process. To do so, we start out from the internationalisation strategies pursued and their determinants. In a third section we look at how regulation might be influencing global banks' international activity and how it interacts with the business models they choose. Lastly, we present the conclusions, which pull together the evidence of the restructuring carried out by many of the global banks in the past few years to cope with a more demanding regulatory environment and a weaker economic and operating climate, with trimmed expectations of profitability.

### Development over time and geographically: the global crisis as inflection point

The internationalisation of banking is a process which has been through two clearly differentiated phases from the 1990s until now: *an initial phase of continuous growth up until the economic and financial crisis of 2008, from which point on we see the beginnings of a trend towards stagnation and even a slight contraction* (Claessens et al, 2013). The total number of foreign banks fell from 1,445 in 2009 to 1,368 in 2013, the reduction being across the board for all groups of countries with different levels of income<sup>1</sup> (Figure 1).

Figure 1

**No. of foreign banks (host country<sup>2</sup>); No. of foreign banks / Total No. of banks worldwide (%)**



Source: BBVA Research based on Bank Ownership Database (Claessens and Van Horen)

1: Classification by level of income distinguishing among: OECD countries (OECD); other high income countries (OHI) established by the World Bank in 2000 and not belonging to the OECD; emerging markets (EM) included in S&P's Emerging Market and Frontier Markets Index and not included in the OHI category in 2000; and all remaining countries, which are classed as developing (DEV).

2: By way of explanation, in the case of OECD countries, the number of foreign banks includes banks whose main shareholders are from a country (whether OECD or not) other than the host country. All host countries in the OECD group are OECD countries.

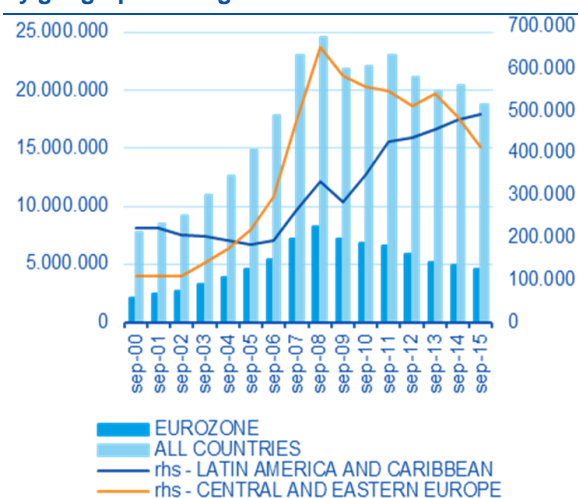
However, this development has not been uniform. Figures 8, 9, 10 and 11, in Appendix I, show the change over time in the number of foreign banks in a country as a percentage of the total number of banks in that country for the years 1995, 2002, 2009 and 2013 respectively. From 1995 to 2009 there was considerable growth. However, the global crisis brought a halt to the process of internationalisation, leading to a slight reduction in the number of foreign banks in certain countries, as can be seen in 2013 for Australia, Ukraine, Lithuania, Russia and Niger.

Throughout the period, the most significant increases in foreign banking presence were in Eastern Europe and Central America. There were also increases, albeit less marked, in North and Central Africa and in South America. In this latter case the most significant growth took place from 1995 to 2002. In Western Europe, there have been few changes, the presence of foreign banks remaining relatively limited except in the Benelux countries and the UK. In Spain, the percentage of foreign banks is quite low in relative terms, although it increased from 2009 to 2013 partly as a result of the Spanish banking sector's consolidation process following the crisis, which led to foreign banks' gaining weight in relative terms by number of institutions.

Also, countries with important financial centres, such as the UK, Singapore and Hong Kong, have high levels of foreign banking presence. Lastly, there are some countries, basically in Asia, where penetration by foreign banks has been and continues to be relatively low. In the case of China it seems to be increasing slowly but surely.

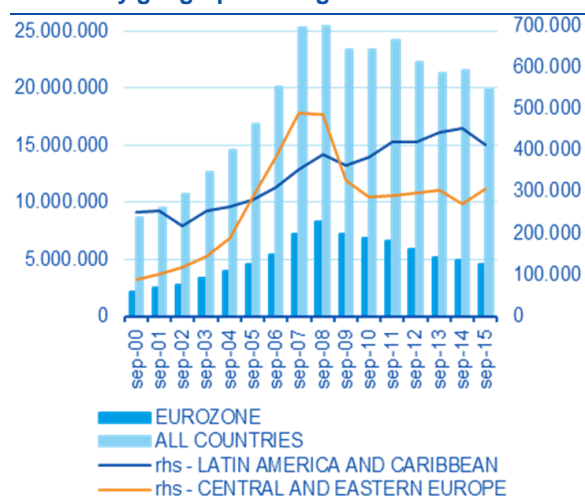
This process of stagnation and slight withdrawal can be looked at from an additional perspective. As well as the reduction in the presence of foreign banks, the economic and financial **crisis** which reached its peak in 2008 and 2009 **led to faster contraction in cross-border banking flows** (Figures 2 and 3). Until then, crises had affected both the supply of these flows and the demand for them in similar measure (Takats, 2010, Kleimeier et al, 2013). However, the recent crisis led to a considerable reduction in both lending and deposits globally, but with **disparities among geographical regions**: in the *euro zone* deposits dropped less than lending; in *Latin America* lending continued to grow at a good pace following the crisis, whereas deposits slowed and have even decreased in the past few years; and in *Eastern Europe*, although deposits declined faster than loans in the period 2008-2011, in the period 2011-2015 they increased, while loans continued to fall.

Figure 2  
**Cross-border loans (US\$ millions) to all sectors by geographical region**



Source: BBVA Research based on BIS statistics (Table A6)

Figure 3  
**Cross-border deposits (US\$ millions) from all sectors by geographical region**



Source: BBVA Research based on BIS statistics (Table A6)

According to the literature, one of the effects of having scarcer and dearer funding has been a contraction in lending, including cross-border, with the consequent impact on the real economy. This is a more complex and abrupt phenomenon, in which a role is played by such factors as:

- 1) The banking business model.** The reduction is less for banks operating through decentralised subsidiaries than for those working through branches (De Haas et al, 2012, Reinhardt et al, 2014).
- 2) The business strategy.** The reduction in lending is proportionally less for branches and subsidiaries of banks whose funding comes mainly from deposits than it is for those whose funding is based on cross-border, intra-group and foreign currency borrowings (McGuire et al, 2016).
- 3) Banks' specific variables.** Lending is affected less in banks with more capital, bigger liquidity buffers (Buch et al, 2014) and stable deposit bases (De Haas et al, 2014).
- 4) Uncertainty and risk aversion.** The greater the uncertainty, the less new lending. Banks reduce lending abroad even more when the level of uncertainty in the foreign country surpasses that at home (Milesi-Ferretti et al, 2011, Düwel et al, 2011, Buch et al, 2014).
- 5) Public assistance.** In many cases banks are obliged to reduce their assets and their international presence (Buch et al, 2013). In the European Union, with the aim of not distorting banking competition, this assistance was tied to additional requirements such as limiting management bodies' pay, granting a minimum percentage of loans to the real economy, etc.
- 6) Countries' macroeconomic, financial and cultural variables.** Banks cut lending less to markets that are geographically close and culturally similar and where they have more experience with habitual customers (De Haas et al, 2012).
- 7) Preference for home base.** As business opportunities decrease, banks invest in other financial assets with which they are more familiar, such as their home countries' public debt.

### Implications of internationalisation for host countries

The entry of a foreign bank entails a number of pros and cons for the host country, displaying a **disjunction between efficiency and financial stability**. Until the crisis of 2008, benefits usually outweighed costs. However, the global crisis widened the variety of results obtained.

#### a) Efficiency of the banking system and access to financial services

An increased presence of foreign banks in a country leads to a **fall in the costs of financial intermediation** for the banking system as a whole, increasing competition in the sector. There will also be an **increase in the quality of intermediation**, and the authorities may have an incentive to make regulation and supervision more detailed and transparent (Claessens et al, 2013). Other effects are gains in human capital with greater international experience and advances in technology, marketing and business organisation (Gopalan, 2015).

This greater efficiency translates into financial development of the host country in two dimensions: 1) Greater variety of products and services offered to customers; and 2) Increased lending and improved payment terms for households and businesses. There needs to be a caveat in respect of this increase, since if foreign banks' lending in low income countries is mainly to higher income groups, domestic banks may see even greater contraction in their lending given the greater risk and lower profitability, and this might have a negative effect on the real economy as a whole.

#### b) Financial stability

Before 2008, crises were national or regional, not global, and they led to investment in countries not affected by them, aimed at diversifying risks. In this situation, foreign banks with centralised business models are a

**source of financial and economic stability** since they receive funds from their respective parents. However, with the global crisis that started in the advanced economies, some banks – basically those operating mainly through branches and with models featuring less internal autonomy - became **sources of instability**, acting as transmitters of the international crisis to the economies of their countries, through channels as the granting of credit to the real economy (Claessens et al, 2013).

The experience of Eastern Europe and Latin America shows that the business model chosen plays a fundamental role in countries' financial stability (Fernández de Lis et al, 2013). As can be seen in Figures 2 and 3 above, **the reduction in banking flows has been much more pronounced in Eastern Europe than in Latin America.**

In the former case, the foreign banks operate through subsidiaries and branches which depend on the liquidity provided by the parent (Fernández de Lis et al, 2015). At the onset of the global crisis, the problems **in Eastern Europe** deteriorated to a greater extent, since the local currencies depreciated more and a considerable proportion of the loans granted in these countries were denominated in foreign currency. Moreover, since this centralised business model is based on intra-group financing, when the interbank market dried up, banks started to have liquidity problems and there was a massive withdrawal of funds back to the parents. As can be seen, this model had a negative effect on the real economy since there was an abrupt contraction in lending and negatively affected the financial stability of the country in question. The impact would have been much greater and more prolonged had it not been for the signing of the so-called **Vienna Initiative**, implemented in January 2009 and revised at the end of 2011 (driven by the IMF and the region's central banks). Its objective was to ensure that European banks continued to support their subsidiaries thus safeguarding the financial stability of the countries of Eastern Europe.

Therefore with this centralised business model close coordination is needed between the regulators of the host and home countries. For this, it is essential that all countries, including emerging ones, adopt a common framework for action to ensure the stability of their financial systems (Claessens et al, 2014b).

On the other hand, **Latin America**, where foreign banks predominantly operate with decentralised business models, has withstood the global crisis better. This is largely explained by banks' business models based on capturing local deposits and mainly carried out by decentralised subsidiaries with a high degree of autonomy capital and liquidity management. Although profits are lower in the short term because of a more costly allocation of resources, in the long term the countries' financial stability is protected.

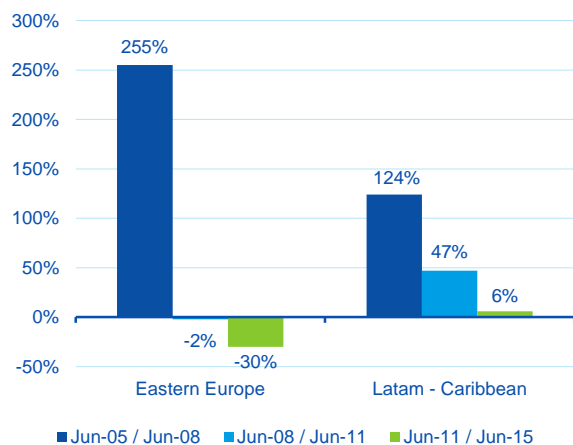
This is reflected in Figures 4 and 5, which show the **differences between Eastern Europe and Latin America/Caribbean**. The former shows the percentage change in the periods June 2005/08, June 2008/11 and June 2011/15 in cross-border loans by global banks to banks in Eastern Europe, and Latin America and the Caribbean based on the territorial principle, assigning banks' loans to their branches and/or subsidiaries.

The second one shows the percentage change in the periods June 2005/08, June 2008/11 and June 2011/15 in global banks' consolidated exposure abroad<sup>3</sup> to all economic agents in Eastern Europe and Latin America and the Caribbean. In this latter case the Spanish banks are differentiated from the rest. As a result, Spanish banks' loans to their Latin American subsidiaries are not included, since all intra-group loans are eliminated in any consolidation process, but their subsidiaries' and branches' loans to host country economic agents are included.

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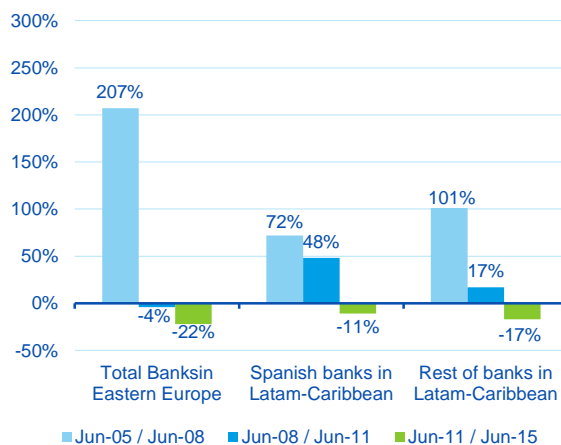
3: According to the BIS, it includes cross-border claims plus claims of the global banks' subsidiaries and branches on the host country.

Figure 4  
Change (%) in cross-border loans to banks by geographical region



Source: BBVA Research based on BIS statistics (Table A6)

Figure 5  
Consolidated change (%) in cross-border loans to all sectors by geographical region



Source: BBVA Research based on BIS statistics (Table B4)

## 2. Internationalisation strategies and their determinants

**Banks can expand abroad by means of cross-border lending or by establishing a physical presence.** Cross-border loans are used, among other things, to finance businesses' trading and services activities, or for major institutional or corporate projects for example in the form of syndicated loans.

If a bank chooses to physical establishments in their international expansion, banks' choice of their legal structure is crucial, so in this section we will analyse its determinants.

### Subsidiaries or branches

Banks may opt for international expansion with a physical presence in the destination country through branches or through subsidiaries. A **branch** does not have a legal personality of its own and depends directly on the parent bank, which is its exclusive owner. While it benefits from the coordinated management of assets, capital and liquidity within the group, the risk of contagion in the group increases since losses are ultimately borne by the parent. A **subsidiary** is an independent legal entity with limited liability, with a greater or lesser degree of autonomy depending on how decentralised the business model is, normally funded locally, subject to host country supervision and covered by the host country's deposit guarantee fund. The subsidiary's balance sheet and income statement are consolidated in the financial statements of the parent after deduction of any proportion of profits attributable to minority shareholders.

Banks can opt for a subsidiary model, a branch model or a mixture of both (Fiechter et al, 2011). This decision depends on several factors:

- **Business strategy and penetration of the foreign market.** The **business model typical of banks** that opt to expand through **branches is the centralised** one, with a large number of interconnections within the group and with centralised management of capital, liquidity, technology, etc. This centralised model is best suited for banks whose business is geared to wholesale and investment banking.

Banks opting for **subsidiaries usually have a more decentralised business model** focusing more on retail customers. They are usually self-sufficient, whereby each subsidiary is independent financially (capital and liquidity), legally and operationally with respect to the other parts of the group. Subsidiaries fund themselves for their own account, accessing the domestic markets in which they operate or the

international markets. Support from the parent to the subsidiaries is possible, but restricted and always at market prices. This model better safeguards financial stability, since it avoids contagion to other parts of the group. However, greater autonomy involves greater costs, since the independent management of capital and liquidity by subsidiaries is usually more expensive than that of branches (because of fewer economies of scale in funding). In branches it is easier to reallocate resources from a less productive part of the bank to another in which better profits can be obtained.

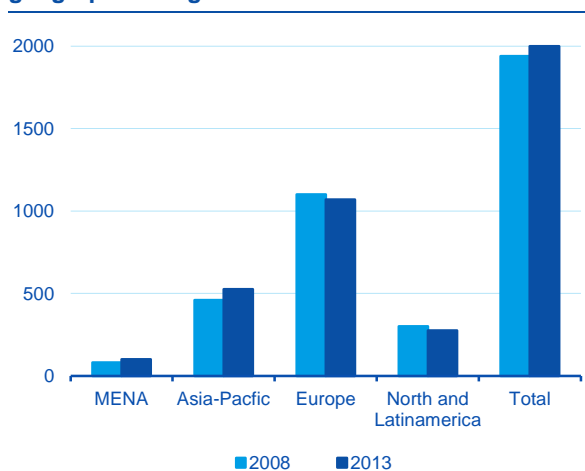
On the other hand, the strategy for entering a market, especially by means of acquisitions, may preclude the choice between branch and subsidiary. For example, Spanish bank's expansion in Latin America was by means of buying local banks which they subsequently turned into independent subsidiaries, since they had autonomous legal structures with branch networks and broad deposit bases.

- **Tax on income.** The treatment varies from one country to another. In high tax countries, the branch model may be more efficient since this legal structure makes it easier to repatriate profits to another part of the bank located in a country with lower taxation (Cerutti et al, 2007). In contrast subsidiaries pay tax in the country in which they are incorporated.
- **Country risk.** If the macroeconomic risk is high, subsidiaries are preferable due to their limited liability, which mitigates any possible contagion to the group. However, branches are less exposed to the risk of expropriation - among other things because the capital remains with the parent - (Dell' Ariccia et al, 2010).
- **Regulation.** Regulation affects the choice between an expansion model based on branches and one based on subsidiaries in different ways.
  - For example, in the case of a branch, **supervision** is generally carried out by the home country, whereas subsidiaries are overseen by the host country's supervisory authority. As for **solvency regulations**, subsidiaries have to meet the host country's requirements, which branches do not. It is the parent company that needs to comply with the solvency requirements of the home country. However, **since the onset of the crisis, differences between branches and subsidiaries as regards supervision and regulation have tended to diminish.** Host country supervisors have tightened control of the institutions operating in their territory. For example, in the EU the Single Supervisory Mechanism (SSM) extends the European Central Bank's supervision to branches of banks whose parents are based outside the Banking Union.
  - There are also **cases in which the decision is imposed by the host country's regulator.** Host country regulators may oblige foreign banks to operate through subsidiaries. For example, in the UK the Prudential Regulation Authority obliges banks from outside the European Economic Area to operate with subsidiaries if it considers the home state supervision not to be equivalent, if the level of assurance over resolution to be insufficient, or if the foreign bank in question intends to carry out critical economic functions in the UK. Similarly, the regulators of the home country may impose the legal structure of the bank in question (for example Banco de España preferred expansion through subsidiaries in Latin America so as to avoid the risk of contagion to Spain).
  - Another important aspect, as was seen with the failure of the Icelandic banks, is that subsidiaries' deposits are usually covered by host country **deposit guarantee systems**, whereas branches depend on those of the parent's home country. There are exceptions however. One case is Spain, where the law obliges branches of banks from outside the European Union to join the Deposit Guarantee Fund if the home country's deposit guarantee system provides less cover.
  - Banks' legal structure is also affected by the **new resolution framework**, as we shall see in the following section.

- New technologies.** Digitisation, developments in payment systems and the growth of online and mobile banking may lead in the long term to physical presence becoming less important in offering financial products and services. Retail banking has traditionally required the opening of offices, and most banks with a retail presence in a foreign country opted to set up a subsidiary or acquire another bank. But with the more widespread adoption of online banking, international expansion of retail banking can be achieved through branches or even without branches. The branch model based on deposit gathering does however face certain difficulties outside the EU due to the greater differences at regulatory level, particularly as regards different coverage requirements for deposit guarantee systems, and to the risks in terms of financial stability in the host countries.

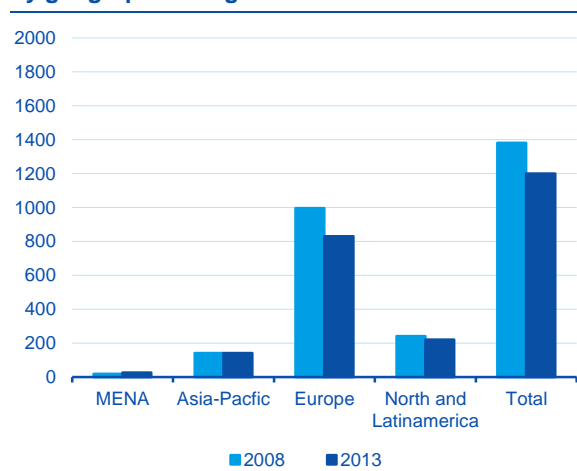
In general, banks try to optimise the legal structure of their cross-border business and present a **mixed structure of branches and subsidiaries**, sometimes even within a single host country. There are also occasions when the differences between branches and subsidiaries are less marked. In the case of subsidiaries there are different degrees of autonomy, ranging from subsidiaries with a high degree of interconnection (in terms of capital and liquidity for example) with their parent to stand-alone subsidiaries such as those of Spanish banks in Latin America. Branches' degree of independence can also be affected by the host country authorities' erecting barriers between them and the parent (ring fencing)<sup>4</sup>. Host country authorities may demand to maintain a degree of control at times of crisis and thus avoid the repatriation of resources to the parent or the transfer of toxic assets to the branch. Indeed, in the summer of 2015 some Eastern European countries opted to impose ring-fencing measures (additional controls and limits on transactions) to avoid a flight of funds from branches of Greek banks to their parents in Greece.

Figure 6  
**(2008 vs. 2013) – Number of foreign branches by geographical region**



Source: BBVA Research based on IMF data

Figure 7  
**(2008 vs. 2013) – Number of foreign subsidiaries by geographical region**



Source: BBVA Research based on IMF data

In the light of the crisis and the consequent increase in regulation, banks are revisiting their legal structure to bring it into line with their business model. Figures 6 and 7 show the **number of foreign branches and subsidiaries by geographical region (in 2008 and 2013)**. In Europe we see relative “branchification”, with a very significant decline in the number of subsidiaries in existence (-175) compared with the decline in the number of branches (-9). This is explained by the existence of a common market and the subsequent creation of the banking union.

4: We should stress that in this context ring fencing refers to the erecting of barriers between branch and parent, not to ring fencing regulations in terms of the segregation of activities as for example in the UK.



The foregoing Figures lead one to wonder whether certain institutions are looking at converting their branches into subsidiaries and vice versa. The changes in the legal structures may be explained by a drive to reduce costs, a move to bring these structures into line with the degree of centralisation or decentralisation of their business models, but also by the impact of new regulations, especially in the area of resolution. We should also highlight the fact that the degree of legal harmonisation plays a significant role in the choice of one or other legal structure. For example, the euro zone is en route to becoming a single banking jurisdiction thanks to the creation of a common framework for supervision and resolution, the banking union, in which it might be more profitable to operate with more centralised business models.

### 3. Impact of regulation on global banks' expansion

Financial regulation is one of the most important factors influencing global banks' internationalisation strategies and *modi operandi*. In this section we look at the regulations that we believe have the most significant impact on global bank's expansion strategies. According to Ichiue et al (2016), the new regulations resulting from the financial reforms following the crisis have reduced banks' international activity. Additionally, they indicate that regulatory changes in banks' home countries have a greater effect on their international presence than do those in host countries.

#### Capital and liquidity requirements

Increased capital requirements mean that banks in general, and global banks in particular, are more demanding when deciding in which areas of business and geographical regions to be present. **Capital is too scarce and dear a resource to waste on activities or countries in which profitability is unclear or harder to achieve than before or which regulation has simply made insufficiently attractive.** For this reason several of the global banks' restructuring announcements mention reasons relating to capital requirements or the low profitability of certain business lines.

**It is true that restructuring operations are more significant or common in business lines related to investment banking.** Several banks have decided to reduce the proportion of risk-weighted assets allocated to these activities in order to focus on areas in which they believe they have a comparative advantage. For example some banks have opted to refocus on wealth management and private banking in view of the greater revenue stability and lower capital consumption. According to a recent article by Goodhart et al (2016), the big winners are the US investment banks, whose market share has increased to the detriment of their European counterparts, and which now dominate global investment banking.

Other regulations which largely affect investment banks are the obligation to clear derivative contracts through central counterparties (EMIR in Europe, Dodd-Frank in the US) and questions of pre-trade and post-trade transparency such as the obligation to publish prices of OTC derivatives (MiFIR/MiFID). Several global banks have referred to regulatory pressures and weaknesses in this activity, in particular in fixed income, currency and commodity markets, as reasons for restructuring their investment banking.

Also, **the introduction of limits on leverage ratios makes several investment banking activities less attractive.** Because the leverage ratio does not distinguish among assets, it severely penalises investment banks. Before the leverage ratio was introduced, investment banks did not have to hold any capital (or very little) for a very significant portion of their balance sheets (all assets considered low-risk, such as government debt or other asset classes with high credit ratings). **The revision of capital consumption for trading portfolios currently being prepared by the Basel Committee** is another factor that may have an impact on global bank's business decisions.

Additionally, with the introduction of **Basel III, the treatment of minority interests is less favourable than under Basel II**, since previously all minority interests were eligible for Tier 1 at consolidated level, whereas

under Basel III minority interests that exceed the minimum capital requirements in the subsidiary have to be deducted.

Lastly, with regard to **liquidity requirements**, the Net Stable Funding Ratio (NSFR) does not come into force until 2018, and the Liquidity Coverage Ratio (LCR) is being phased in, facilitating its compliance. Nevertheless, the business of intermediation in public debt has become less attractive to banks, whether because of the increased capital consumption associated with this activity, the leverage ratio or the need to separate trading activities from retail banking, and this is leading to reduced liquidity in these markets.

### The new resolution framework

Each bank's **resolution strategy is adapted to its business model**. Even so, this relatively new aspect of regulation is having, or may turn out to have, a significant effect on global banks' behaviour. For example, during the preventive phase, the resolution authority has the power to oblige a bank to make changes to its business model and legal structure in order to facilitate its resolution.

**Regulation in general (and resolution regulation in particular) should respect banks' different business models.** Thus a bank's choice of resolution strategy ought to be independent of the regulatory requirements. However, some countries seem to favour banks with Single Point of Entry (SPE) resolution strategies over those opting for Multiple Point of Entry (MPE)<sup>5</sup>. This may lead to institutions reconsidering their resolution strategy when operating in certain markets or countries.

When the Spanish banks expanded into Latin America, the comparative advantage they had was in retail banking, of a local nature *par excellence*. On the one hand the business model had to be decentralised in order to limit exposure to the risks deriving from the region (and thus satisfy the Spanish authorities), and on the other hand it needed to give the subsidiaries a degree of independence and also satisfy the host countries' authorities, which have always considered these banks as domestic. In this regard, **for banks with decentralised management** (basically of capital and liquidity, and mainly operating through subsidiaries with a high degree of autonomy) **the most appropriate resolution strategy is MPE**. These subsidiaries each report to the host country's resolution authority, which applies its own regulatory framework. Each resolution entity or subsidiary is subjected to a separate resolution process, and must have sufficient loss-absorbing capacity at individual level.

For banks with more centralised management and a considerable volume of intra-group loans, the natural resolution strategy is the SPE (Single Point of Entry). Liabilities with loss-absorbing capacity (MREL/TLAC<sup>6</sup>) are issued by the parent to external investors. The parent in turn distributes the TLAC/MREL raised externally to its main branches and/or subsidiaries by way of intra-group loans, capital or collateralised guarantees (the so-called internal TLAC or MREL).

For branches that capture deposits, the level of cooperation and coordination between home and host authorities, and the degree of harmonisation of the resolution regimes need to be greater than they do for subsidiaries: both in the preventive phase (when developing resolution plans and setting MREL/TLAC loss absorption requirements) and in the execution phase of the resolution.

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5: With an SPE model, a single authority applies the resolution tools at the level of the parent bank. Losses incurred by subsidiaries are absorbed by the parent, which in turn recapitalises the subsidiary so that it can continue operating. With an MPE model, the resolution tools are separately applied by one or more resolution authorities in one or more parts of the banking group. The application of a resolution tool in one part of the bank need not necessarily be the same as that applied to another part of the entity. For further information, see [https://www.bbva-research.com/wp-content/uploads/2014/12/20141215\\_Compedium-on-resolution-strategies\\_MPE-Vdef2.pdf](https://www.bbva-research.com/wp-content/uploads/2014/12/20141215_Compedium-on-resolution-strategies_MPE-Vdef2.pdf).

6: Total Loss Absorbing Capacity (TLAC) is an international requirement published by the FSB in 2015 obliging banks to hold sufficient liabilities with the capacity to absorb losses. Its equivalent in Europe is the Minimum Requirement on Own Funds and Eligible Liabilities (MREL). MREL and TLAC are the cornerstones of the new resolution regime, in which shareholders and creditors have to assume much of the burden of recapitalising a bank when it fails.

In the euro zone and in the European Union, with the launch of the banking union and a common legal framework for resolution (the Bank Recovery and Resolution Directive, or BRRD) it would make sense even for banks with decentralised management models to consider an SPE resolution strategy. **In the Banking Union, it is not so obvious that the advantages of a decentralised model in preventing contagion among different geographical areas are enough to make up for the increased cost and the loss of efficiency entailed.**

Also, as mentioned previously, changes to legal structures can be imposed by the authorities. **In Europe, the SRB (Single Resolution Board) can oblige banks to make changes to their structures in order to facilitate a hypothetical resolution.**

However, although the data up to 2013 show the contrary (see Figures 6 and 7 above), the current state of implementation of resolution regimes internationally does not support a move towards “branchification” but rather “subsidiarisation”. According to a recent study by the FSB<sup>7</sup>, there are very few jurisdictions with advanced resolution frameworks (EU, US, Switzerland and Japan). The remaining G-20 members are developing legislative reforms to bring their resolution regimes into line with the FSB’s Key Attributes<sup>8</sup>. Outside the G-20 hardly any countries have resolution frameworks conforming to the principles of the FSB. **This divergence among resolution frameworks makes it more difficult to implement an SPE resolution strategy, since it requires greater coordination between home and host authorities.**

Another aspect to bear in mind is the **provision of liquidity in a resolution**. The role of lender of last resort is assumed by the host country’s central bank. Banks with a decentralised business model (and an MPE resolution strategy) obviously pose fewer challenges to the central banks in question, since they usually have fewer liabilities denominated in foreign currency vis-à-vis the host country.

**Finally, a bank’s resolution strategy must be aligned with its operating and business model.** The manner in which a bank conducts its global business is in turn partly determined by its own comparative advantages, the countries in which it operates, the regulation in the countries into which it decides to expand and global regulation in general.

### Segregation of activities

Another of the reforms having or likely to have a considerable effect on banks’ business models and legal structures is the **separation of retail banking from wholesale/investment banking**. This separation is closely related to bank recovery and resolution, since it could facilitate the process and ensure the continuity of critical operations. In line with the now repealed US Glass-Steagall Act of 1933, various jurisdictions such as the UK have already passed laws in this respect. The Banking Reform Act 2013 requires the ring-fencing of certain retail businesses in separate legal entities within the same group by 1 January 2019, when the law comes into force.

**The ring-fencing of businesses poses an operational challenge for banks**, since they have to implement completely separate management strategies.

The US passed a similar law, the “Volcker Rule”, which forms part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), prohibiting certain risky activities (short-term proprietary trading, investing in hedge funds, etc.). In Europe no such law has yet been enacted, although it has been under discussion since the Liikanen report of 2012.

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7: <http://www.fsb.org/wp-content/uploads/Report-to-the-G20-on-Progress-in-Resolution-for-publication-final.pdf>

8: The Key Attributes (published by the Financial Stability Board in 2011) contain a series of recommendations for setting up an efficient resolution framework. These are international principles which have to be transposed into the legislation of the various jurisdictions in order to be legally binding.

## Authorities' preferences and differences between those of host and home country authorities

The alignment, or lack of it, between host and home countries' authorities is one of the factors determining the *modus operandi*, the model chosen, the legal structure and whether to expand in or withdraw from a given country. **The Spanish and Latin American regulators' preference for foreign banks to operate through subsidiaries, with a degree of autonomy vis-à-vis their parent bank, favoured the Spanish banks' decentralised model** in their expansion to emerging countries (Fernández de Lis et al, 2015). The advantages of this model were seen clearly in times of crisis, preventing contagion from subsidiaries to parents as in the Argentine crisis of 2001 and from parents to subsidiaries as in the recent crisis in Spain.

The **Vienna Initiative**, mentioned previously, was one of the responses to the lack of coordination between host and home countries' authorities. The main objective of this initiative was to maintain financial stability in host countries, making sure that European banks with subsidiaries and branches in Eastern Europe kept up their support for them in terms of capital and liquidity and that even government assistance in home countries could be extended to subsidiaries and branches in Eastern Europe. This move acted as **a sharp brake on the withdrawal of European banks with centralised business models** and contributed to mitigating problems of financial instability in the region.

**Regulators' and supervisors' preferences are a factor influencing banks' behaviour. The demands made by the US Federal Reserve** of all foreign banks (for example, obliging them to set up a US holding company if the bank's assets are more than US\$50 bn)<sup>9</sup> **set limits on and to some extent determine the actions of all foreign banks in the US.**

On the other hand, **in the European Union, and especially in the countries under the Single Supervisory Mechanism, it is normal that the business model (centralised-decentralised) and the legal form of operation (subsidiaries or branches) should become less important.** The progress made on the banking union (the Single Supervisor, the Single Resolution Mechanism, the Single Resolution Fund and perhaps soon the common Deposit Guarantee Fund) and the adoption of harmonised regulations will gradually eliminate the importance of the home country in the provision of financial services.

## Degree of advancement in regulatory implementation

**The differences among regulations of various countries can lead to regulatory arbitrage**, which is no doubt taken into consideration by global banks when analysing their geographical presence, legal structure and business model. Withdrawal from certain countries may be associated with the implementation of regulations that are more restrictive and less well disposed to the presence of global banks. **Tougher regulations in host countries may lead to global banks' withdrawal.** And, on the other hand, increased regulation in home countries may also lead to withdrawal from emerging countries because of stricter regulation at consolidated level. Regulatory differences may favour banks from emerging countries in their expansion to other countries in the region insofar as they are not subject to the same regulations as banks from developed countries with a presence there<sup>10</sup>.

Moreover, regulatory arbitrage, whereby certain banks seek to circumvent stricter regulations, continues to be an important factor (Ichiue et al, 2016). In this sense, a bank with a global presence will wish to have regulatory harmonisation providing legal certainty and a level playing field for global, regional and local banks.

9: A commercial company whose sole function is to hold and administer the ownership of other companies and which does not usually have operating liabilities.

10: This can also be inferred from the FMI's Global Financial Stability Report of October 2013.

## 4. Conclusions

**Global banks operate in developed and emerging markets**, carrying out retail, corporate and investment banking operations and using legal structures combining branches and subsidiaries depending on their business model (centralised or decentralised). In the past few years there has been a generalised tendency for these banks to withdraw from certain geographical regions and business lines.

The presence of foreign banks, which had increased considerably until the financial crisis, has stagnated since 2009 and even diminished slightly, and international banking flows have also decreased in some parts of the world. **In Asia, setting up branches seems to be more common. In Latin America, foreign banks' presence is basically in the form of subsidiaries**, which seems to reflect the type of banking conducted in the region, with greater predominance of retail banking, as well as the regulators' preference for this legal form. Indeed, except in the EU, host countries' authorities distrust deposit-raising branches of foreign banks. As for **Western Europe, with very few exceptions large-scale retail banking is associated with the use of subsidiaries**, whereas small-scale retail banking and investment banking are associated more with branches.

**We sense a trend towards subsidiarisation worldwide. The EU might be the exception**, since the new common supervision and resolution framework could lead to a tendency to operate with more centralised business models.

**Several factors explain the retreat of global banks**, such as changes in their strategies or business models, the search for greater profitability and or income stability, efficient allocation of scarce resources, political or social instability or new technologies. However, **there is one determining factor: regulation**. This increased regulation translates into such things as: 1) Stricter capital and liquidity requirements. For example, the introduction of the leverage ratio makes certain banking activities and services less attractive; 2) The new resolution framework. In Europe, the SRB (Single Resolution Board) can oblige institutions to make changes to their legal structures in order to facilitate a hypothetical resolution; 3) The ring-fencing of wholesale and investment banking from retail banking, which becomes an operating challenge for banks; 4) Supervisory authorities' preference for operating with a particular legal structure, as it occurs in the US, where banks with assets of over US\$50 billion are forced to establish a US holding company; and 5) Countries' differing levels and speeds of implementation of regulatory reforms. They all oblige banks, among others, to reconsider such aspects of their strategy as: (i) their activity, seeking more recurring revenues; (ii) the geographical locations in which they operate; and (iii) the degree of centralisation of their business model and the legal form in which their operations are structured.

This process does not exclude banks that received public assistance in the crisis. It tends towards organisational simplification, and restructuring operations have affected investment banking, especially in Europe.

In summary, **progress in regulatory harmonisation on a worldwide scale is desirable** if we are to avoid banks having comparative advantages depending on their country of origin and in order to ensure freedom of establishment **without one business model being favoured over another, irrespective of banks' organisational structure**.

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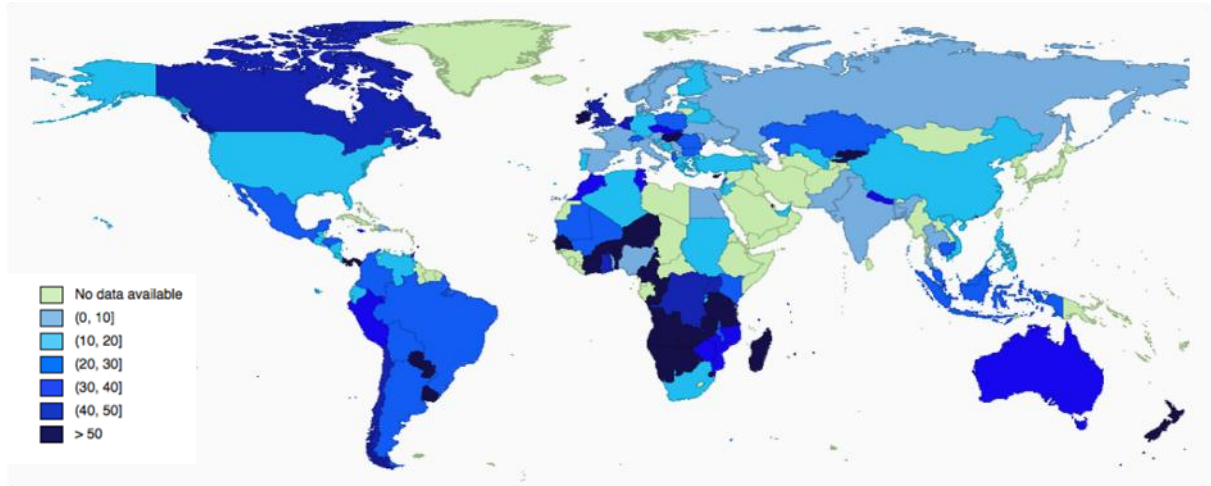
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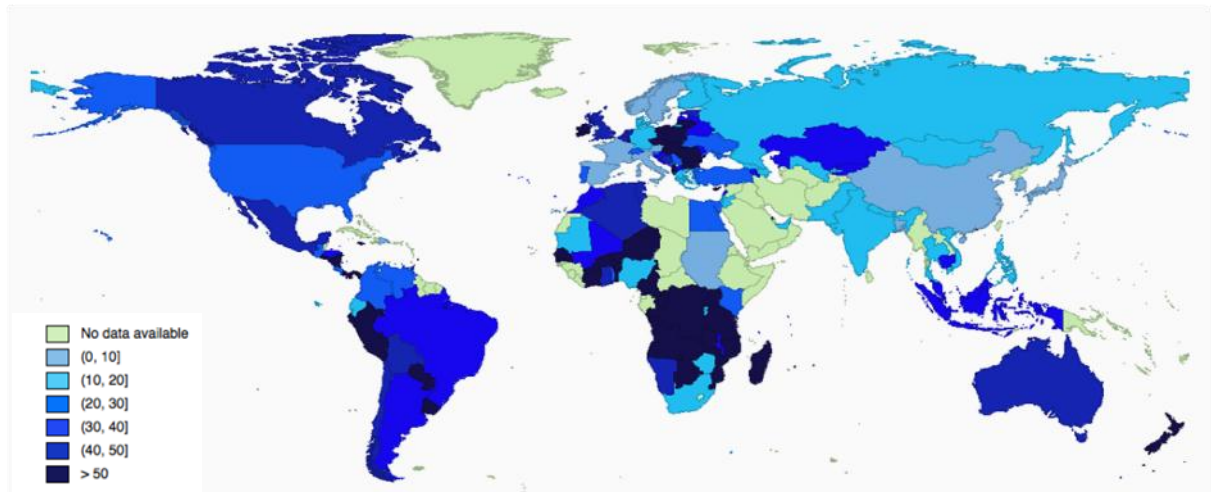
Appendix I

Figure 8  
**1995 - No. of foreign banks / Total no. of banks (%)**



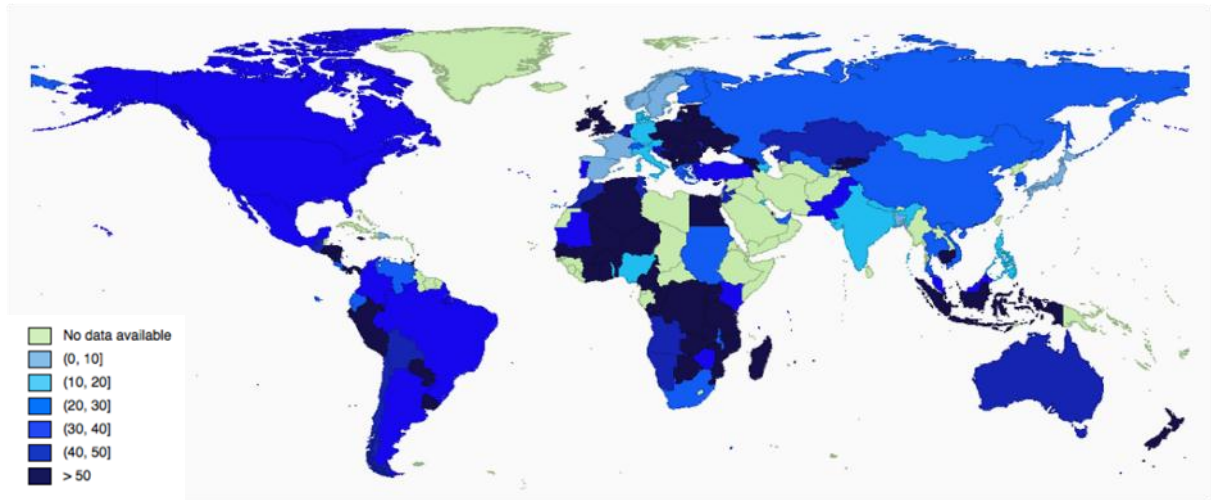
Source: BBVA Research based on Global Financial Development Database (World Bank)

Figure 9  
**2002 - No. of foreign banks / Total no. of banks (%)**



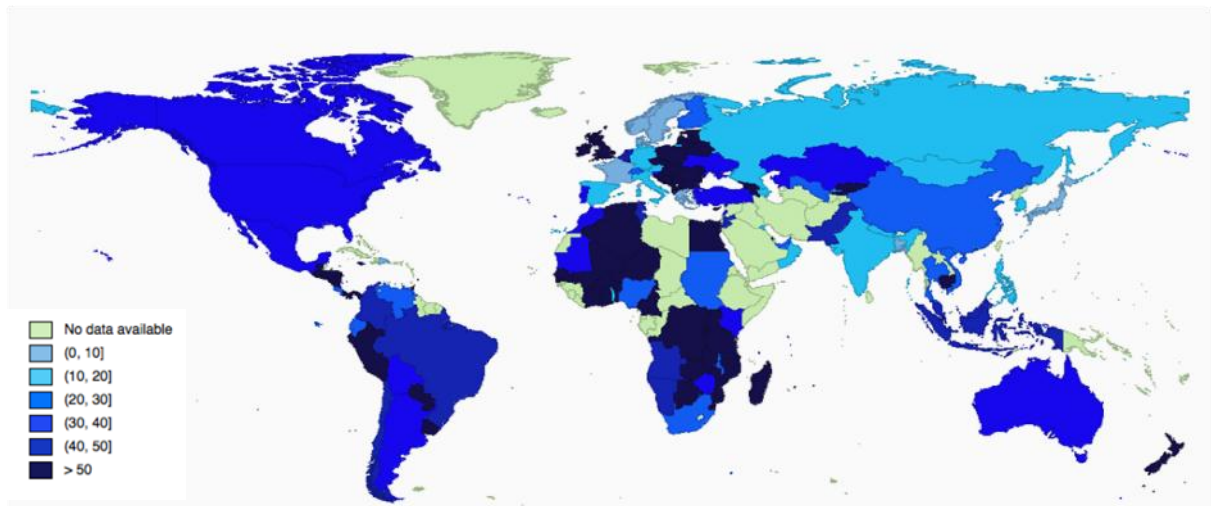
Source: BBVA Research based on Global Financial Development Database (World Bank)

Figure 10  
2009 - No. of foreign banks / Total no. of banks (%)



Source: BBVA Research based on Global Financial Development Database (World Bank)

Figure 11  
2013 - No. of foreign banks / Total no. of banks (%)



Source: BBVA Research based on Global Financial Development Database (World Bank)

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