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Global banks: Branches or subsidiaries?

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A debate that usually arises during the international expansion of banks concerns whether it is better to operate through subsidiaries or branches. A subsidiary is a more decentralized model in which banks adapt to the local business and regulatory environment. The branch model is typical of banks with a more centralized model, where the decisions are made in the parent company. Although both models can co-exist in the same bank, centralized models are generally found in banks with a major investment banking division in which wholesale financing and large intragroup positions predominate (in other words, the parent company directly finances a significant part of the local business). Decentralized models are found in banks with a strong retail business, funded with deposits, with small intragroup positions, where local activity is financed with local resources.

Before the global financial crisis, many international bank models were not closely aligned with their actual legal status. For example, some European Banks operated with retail branches in Eastern Europe through a highly centralized subsidiary model, while the other banks used very local branches funded with deposits.

The crisis revealed the need to align the business model with the legal status. Resolving some cross-border crises has been complicated by doubts regarding who should bear the losses, as in the case of the Icelandic banks in the UK, which had deposits theoretically protected by Iceland's Deposit Guarantee Fund, but they did not have the same protections as the deposits in the home country.

One of the main objectives of international financial reforms has been to ensure the resolution of international banks. The Financial Stability Board has established basic principles that outline two very different models: the “Sing Point of Entry” (SPE) and the “Multiple Point of Entry” (MPE). In the SPE model, the losses generated in the subsidiaries or branches are absorbed by the parent company. In the MPE model, each subsidiary has the capacity to absorb losses, although the parent company may provide support (temporarily and at market prices).

Spanish banks, which use the MPE model Latin America, have proven to be very resilient during the crisis, which has been broadly acknowledged by the main international organizations. There has hardly been any cross-border contagion, compared to the centralized model, in Eastern Europe for example, where parent company financing helped inflate the bubble and, when the crisis broke out, its impact was amplified when lines of financing were cut.

However, the greater resilience of the decentralized model has not been rewarded by regulations. To name two examples: in the U.S., the TLAC rule is stricter for the MPE model and must be articulated through intragroup positions, which makes it harder for the model to work. In Europe, the consolidated regulation establishes requirements that make it hard to calculate the hybrid instruments issue in the subsidiaries.

In the last few years, we have seen many global banks pull out of certain businesses and regions. These moves are partly due to the crisis itself, which has forced some banks to focus on their home country or their core businesses, but it can also be explained by stricter regulations, especially for centralized business models, whose resolution requires a coordinated effort between the home country and the host country. In this regard it is surprising that regulations sometimes punish the decentralized model, which is precisely the one that is easiest to resolve and is better adapted to a world that is more fragmented and exposed to asymmetrical shocks.

As for legal status, we see some divergent trends: one toward “branchization” in the case of the European Union (where there is a common legal framework and, in the Eurozone, a banking union) and another one toward “franchization” in host countries. It will be interesting to see how these trends evolve over the next few years.