DEUTSCHE BUNDESBANK
EUROSYSTEM

Workshop on

“The Costs and Benefits of International Banking”

Eltville, 18 October 2010

David Marques
European Central Bank

Discussion of

“International banks and the cross-border transmission of business cycles“

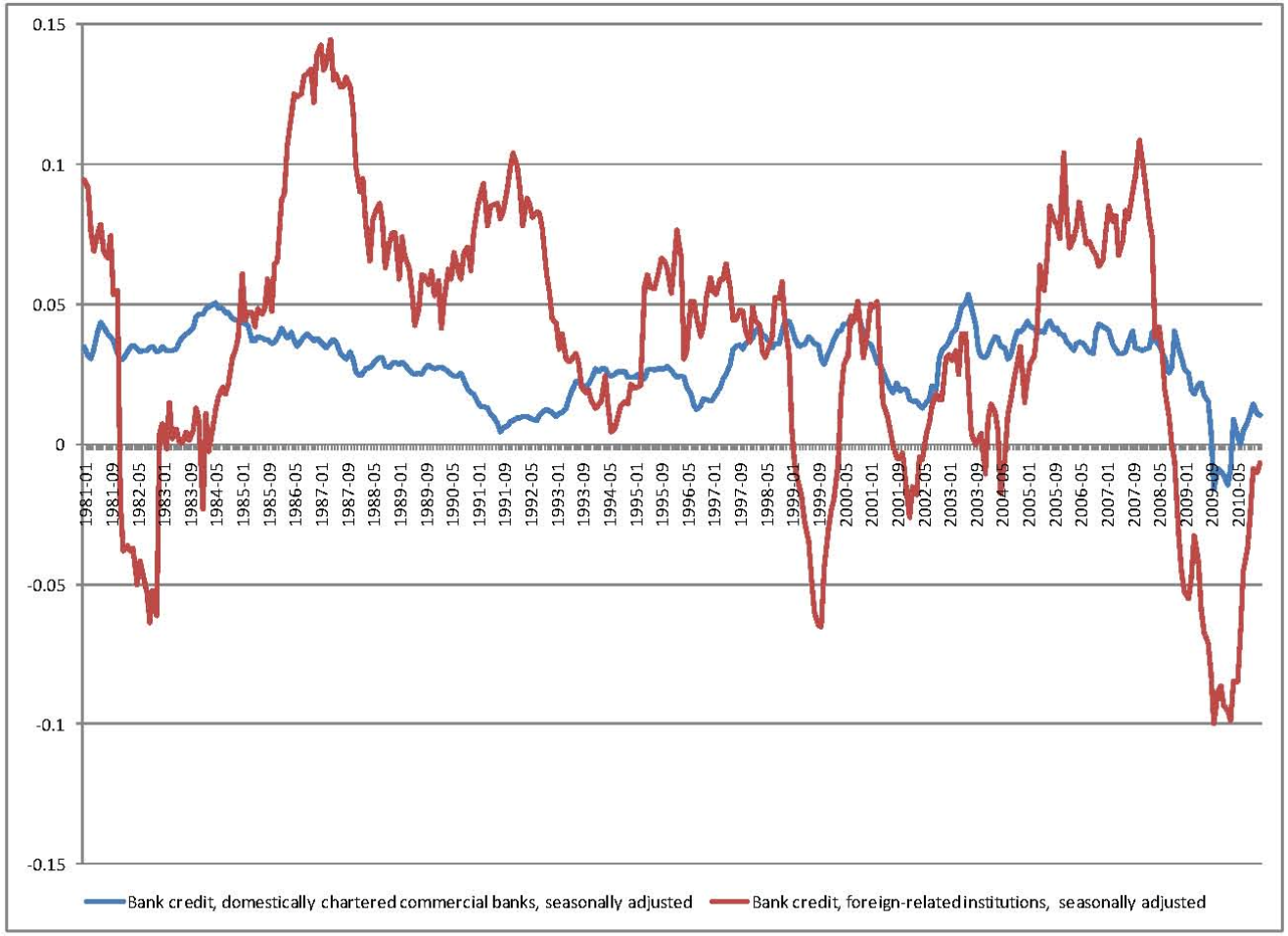
International banks and the Cross-border Transmission of Business shocks

By Ricardo Correa, Horazio Sapriza and Andrei Zlate

David Marques-Ibanez, Financial Research, ECB

The opinions are those of the authors only and do not necessarily involve the views of the European Central Bank

Figure 2. Bank credit growth rates for U.S. domestically chartered banks and foreign related institutions in the United States



Source: Federal Reserve Board (H.8 statistical release).

- Why?
  - Global bank fund themselves with market funding
  - Often short-term, hence not sticky, or stable as retail customer deposits
  - Run-on-fixed income funding => Mason/fortress
  - Pull out lending

Ex-ante

- Deposits tend to be a more stable source of financing as insured (Song and Thakor, 2007, Huang and Ratnovski, 2011). Also due to high switching costs and the transaction retail services (Kim, Kliger, and Vale, 2003),
- Banks increased their dependence on financial markets for funding at relatively low costs,
  - Financial markets investors tend to be relatively sophisticated, => Were expected to provide more market discipline (Calomiris and Kahn, 1991). Really? Outsource…? Free riding?,
  - "Dark side" of wholesale funding: cheap and noisy signals could lead wholesale investors on bank debt to withdraw based on negative public signals, (triggering the liquidation of solvent institutions).

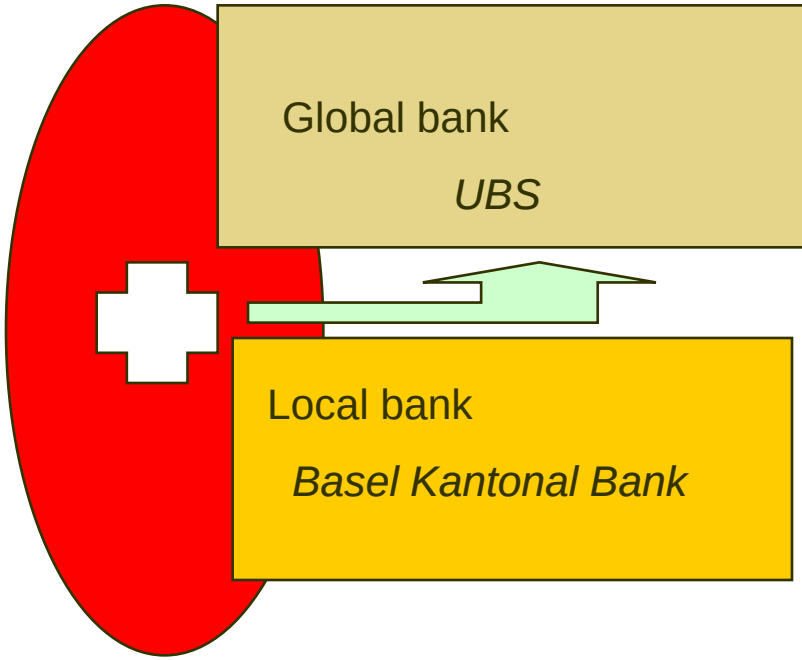
Is it true?

Systematic risk *(only partial results shown)*

		(I)	(II)	(III)	(IV)
Capital structure	Tier I capital	0.0040	-0.0097	-0.0233 ***	-0.0207 ***
		(0.007)	(0.007)	(0.008)	(0.008)
	Undercapitalized		-0.0811 ***	-0.0733 ***	-0.0740 ***
			(0.017)	(0.017)	(0.017)
Asset structure and securitization	Size	0.1039 ***	0.1090 ***	0.1114 ***	0.1041 ***
		(0.031)	(0.032)	(0.033)	(0.036)
	Loan to total assets	0.0083 ***	0.0061 ***	0.0058 **	0.0053 **
		(0.002)	(0.002)	(0.002)	(0.003)
	Securitization	-0.2073 ***	-0.2076 ***	-0.1885 ***	-0.2055 ***
		(0.057)	(0.054)	(0.055)	(0.063)
Funding structure	Short-term market funding	0.0119 ***	0.0097 ***	0.0102 ***	0.0097 ***
		(0.003)	(0.003)	(0.003)	(0.003)
	Deposit funding	-0.0217 ***	-0.0201 ***	-0.0191 ***	-0.0179 ***
		(0.003)	(0.003)	(0.003)	(0.003)
Loan growth and income	Excessive loan growth	0.1560 ***	0.1597 ***	0.1554 ***	0.1597 ***
		(0.026)	(0.027)	(0.028)	(0.030)
	Non-interest income	-0.0050 ***	-0.0043 **	-0.0064 ***	-0.0053 **
		(0.002)	(0.002)	(0.002)	(0.002)
	Profitability			0.1824 ***	0.1705 ***
				(0.049)	(0.049)
	GDP growth				0.2198 **
					(0.110)
	No. of observations	483	483	483	483
	R2	0.4953	0.5172	0.532	0.5352

- Yet, fungibility of debt is the problem
  - This takes regulation as given: branches vs subsidiaries/access to deposit insurance
  - It does not necessarily need to have a global bank to have plenty of market funding
  - Large domestic banks making use of market funding would suffer from same problem

- Question is important
  - Global transmission of shocks
- Model has very interesting features
  - Heterogeneity of banks
  - Elegant use of Ghironi and Melitz (2005)



Impact on third countries also useful

Empirics/Policy…

- The global bank is more productive and issues loans at lower rates
  - More productive or simply larger and riskier (TBTF)?

- Why is a syndicated loan warranted?

- In the event of a shock to firms in Switzerland

  - Retrenchment of Global “foreign banks”
  - In other words/example: a shock in the US would lead to a retrenchment of global European banks pulling out.

- In the current crisis I think we are also interested in the global transmission of shocks due to “financial” conditions
  - Helbling, Huidrom, Kose & Otrok (2011) credit market shocks matter in explaining global business cycles
  - Dedola & Lombardo (2010), focus on the international transmission of shocks in models with financial market frictions
  - Perri and quadrini (2010) endogenously generated credit shocks

- Given that the model is about global banks, banks conditions are bound to have an impact on the transmission of shocks
- What is the role for bank capital for the propagation of shocks?
  - Banks health => Meh and Moran, (2010).
  - Banks' endogenous leverage => Gertler and Karadi (2010).
- Firms can go to global or local banks at different interest rates (lower for global banks), but how spreads relate to borrowers heterogeneity?

- How is the model solved?:
- Important to clarify how to solve the model
  - If solved linearly, is this capturing risks? This would mute volatility (exogenous shocks) and the impact on risks which we aim to capture
  - The coefficients on the terms linear and quadratic are independent of the volatility of the exogenous shocks (Smith- - n Uribe, 2003)
  - Portfolio problem (Devereux and Sutherland, 2007).

- Question is important and I enjoyed reading it
  - Global transmission of shocks

- Model has very interesting features
  - Heterogeneity of banks
  - But focus/aim of paper can be spelt out more clearly

Empirics/Policy…

- Global/Foreign banks are more likely to retrench in bad periods compared to local banks

- Question is are global banks making the financial system riskier?
  - yes?
- Always,
  - No.
- Expansion of very large Spanish banks in Latin America
  - Expansion in the late 1990's and 2000's
  - Good macroeconomic performance in Latin America also boosted by growth in commodities prices globally buttressed large Spanish banks' revenues during the recent crisis
- Does it make them less systemic? Answer is not?
  - Global supervisory mechanism (or at least perspective) warranted.