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Foreign bank presence: Helping or hurting when financial contagion strikes?

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HIGHLIGHTS

- Debt financed by foreign banks may increase the effects of contagion shocks.
- The impact differs with the structure of the banking sector in borrowing countries.
- We estimate bilateral models of bank flows over the 1983–2011 period.
- Bank flows towards domestic banks and firms decrease during contagion shocks.
- Bank flows towards foreign-controlled banks appear less vulnerable.

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ABSTRACT

The spreading of the 2007–09 global financial crisis has highlighted the need to increase the resilience of the financial sector to contagion shocks. Debt financed by foreign banks has been found to increase the financial fragility of the borrowing country in situations of financial contagion, but effects could differ with the structure of the banking sector in the borrowing country. Using bilateral bank flows over the 1983–2011 period, we show that external bank flows towards foreign-controlled banks have been more stable than flows towards domestically-owned banks and firms during financial contagion shocks.

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1. Introduction

The spreading of the 2007–2009 global financial crisis has highlighted the need to increase the resilience of the financial sector to contagion shocks. Debt financed by foreign banks has been found to increase the financial fragility of the borrowing country in situations of financial contagion (see Ahrend and Goujard, 2011), but effects could differ with the structure of the banking sector in the borrowing country. When enterprises or banks of a given country borrow directly from banks abroad this may have a different risk profile than when international lending is channelled through branches or subsidiaries of international banks in the given country. This article explores whether one of these two types of international financing is more robust when a borrowing country is hit by a financial contagion shock.

Circumstantial evidence points to international banks having transferred resources from foreign subsidiaries to their parent banks during the recent financial crisis. Such transfers could starve subsidiaries of funds, thereby reducing lending by these subsidiaries (Cetorelli and Goldberg, 2008). In contrast, domestic banks may be more vulnerable to host country shocks than subsidiaries of foreign banks that can rely on internal capital markets of their multinational parent banks (de Haas and van Lelyveld, 2006). Similarly, when international banks rebalance their portfolios in the wake of negative shocks, they may predominantly withdraw their funds from non-affiliated banks while maintaining their external positions towards foreign affiliates (Broner et al., 2006; Cetorelli and Goldberg, 2011). Which type of international financing is preferable from a financial stability point of view is hence an empirical question.

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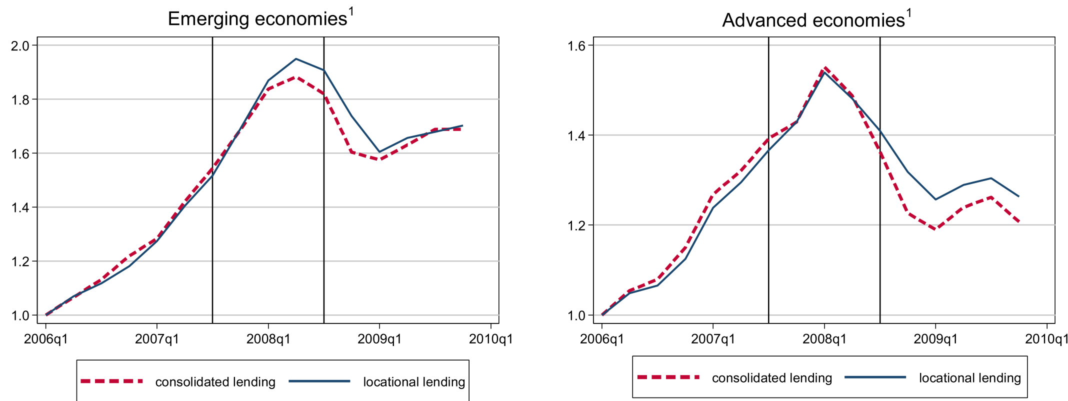

Fig. 1. Proportional growth in consolidated and locational bank lending during the 2007–2009 global financial crisis. Note: The figures display the proportional growth in lending by BIS reporting banks with respect to 2006q1. 1. Emerging and advanced economies are defined according to the IMF WEO classification in Duttagupta et al. (2011). The sample of countries is restricted to the countries with non-missing values for the period 2006q1–2009q4.
Source: BIS quarterly locational and consolidated banking statistics (Tables 6a and 9aa), authors' calculations.

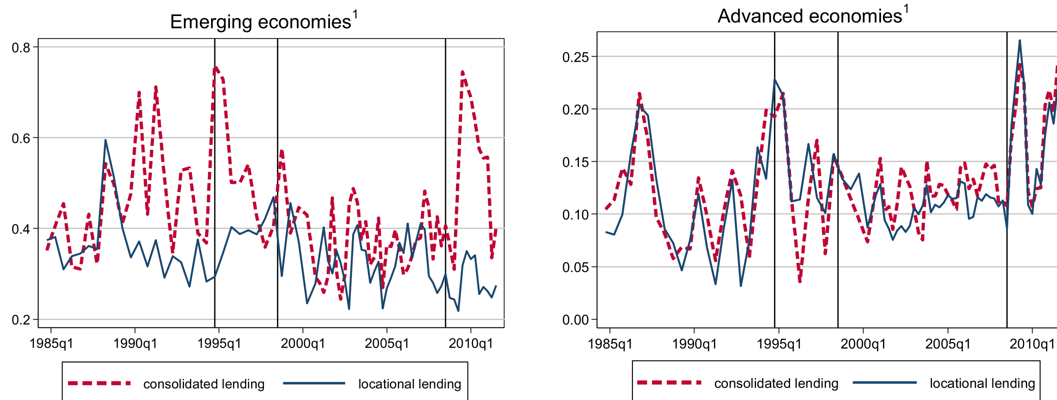

Fig. 2. Cross-sectional volatility of locational and consolidated bank lending growth 1983–2011. Note: The figures display the cross-sectional standard deviation in the yearly growth of lending by BIS reporting banks. Dates of major changes in the methodology of reporting by the BIS have been dropped from the sample. 1. Emerging and advanced economies are defined according to the IMF WEO classification in Duttagupta et al. (2011). The sample of countries is restricted to countries with non-missing values for growth in locational and consolidated bank lending in the same quarter.
Source: BIS quarterly locational and consolidated banking statistics (Tables 6a and 9aa), authors' calculations.

We examine whether international bank flows towards banks' foreign affiliates are affected differently from those towards non affiliated banks or firms when borrowing countries are hit by financial contagion shocks. Bank of International Settlements (BIS) statistics differentiate locational bank flows based on the residency principle (including banks' internal flows towards foreign affiliates) from consolidated bank flows that aggregate locational flows using an ownership principle (and hence exclude banks' internal flows towards foreign affiliates). Therefore, if locational bank flows are less prone to reversals in the case of a financial contagion shock than consolidated bank flows this can be interpreted as evidence that banks' internal flows towards foreign affiliates are more stable than international bank funding channelled directly to foreign banks or enterprises.

We contribute to the literature in several dimensions. First, we use locational and consolidated BIS bank data in an innovative way to estimate a bilateral panel data model that allows controlling for all debtor-country specific shocks and unobserved time-invariant debtor–creditor characteristics. Second, we show that external bank flows towards foreign-controlled banks appear more stable than flows towards domestically-owned banks in case of financial contagion shocks. In other words, external lending by banks without a local presence increases financial fragility more than lending of international banking groups to their local operations in case of international bank-driven contagion.

2. Descriptive evidence

Looking at the development of locational and consolidated bank flows prior to and during the 2007–2009 financial crisis suggests that locational flows were less affected during the crisis (Fig. 1). This implies that during the crisis cross-border flows within international banking groups were more stable than flows related to cross-border lending of international banks to non-affiliated parties, a feature that would seem to hold both for emerging markets and developed economies.

A similar picture emerges when looking at the volatility of bank positions over the 1983–2009 period for advanced and emerging economies (Fig. 2). We report the cross-sectional volatility of the growth in consolidated and locational bank lending for advanced and emerging economies. During major episodes of financial contagion (such as the Mexican crisis end-1994, the Asian crisis in 1997 or the 2007–2009 global financial crisis) the volatility of consolidated bank lending to emerging economies rose sharply while that of locational bank flows remained comparatively stable.

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