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Global banks and internal capital markets: Evidence from bank-level panel data in emerging economies

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A B S T R A C T

In this paper, we examine the operation of internal capital markets within multinational financial conglomerates. We observe the lending behavior of foreign subsidiaries of the major multinational banks which conduct banking activities in emerging and developing countries. Using loan growth-to-internally generated funds sensitivity as a measure of subsidiary's financing constraints, we explore whether such sensitivity is correlated with the availability of internally generated funds at the consolidated banking organizational level, and find robust evidence for the operation of internal capital markets. We also provide evidence that internal capital markets of multinational banks alleviate financial constraints faced by their foreign subsidiaries.

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1. Introduction

This paper examines the existence and operation of internal capital markets between multinational banks and their subsidiaries in developing and emerging economies. Internal capital markets can be established by banks to mitigate capital market friction, as it proves difficult for outsiders to evaluate the assets held by banks and thus becomes costly for banks to raise external capital.[1] Capital market friction leads banks to rely on their own internally generated funds to finance their investments, hence banks with different abundances of internal funds exhibit different loan growth rates. Banks with more internal funds are more likely to increase their loan granting, and vice versa. For banks which belong to a conglomerate, however, the story may differ. By creating internal capital markets and channeling resources, parent banks could dampen subsidiaries' reliance on their own internal funds.

In the recent decade, there has been a growing interest in the determinants of banks' loan granting beyond their own financial characteristics, especially in whether and how parent banks affect the lending behavior of their affiliates. Intuitively, if internal capital markets do exist and work effectively, parent banks (or bank holding companies) are expected to allocate capital and liquidity to support their subsidiaries' lending, hence the financial strength of parent banks would be related to the behavior of subsidiaries. The implication is critically important: it helps us to better understand the causes of credit crunch and its spillovers to countries where subsidiaries are located, independent of the subsidiaries' own characteristics and balance sheet strength.

In this paper, we provide robust evidence for both the existence and operation of internal capital markets in multinational banks. That is, foreign bank subsidiaries are expected to increase their credit in host countries when their parent banks have higher internally generated funds, and the funds available from parent banks reduce the sensitivity of the subsidiaries to their own internal funds. Our finding suggests that there is a linkage between the credit by subsidiaries and the financial strength of their parent banks in multinational banking. Foreign bank subsidiaries could serve as a stabilizing financial force in host economies when their parent banks in home countries are healthy, but could also play a destabilizing role when the opposite holds true.

We also test how internal capital funds are allocated across the subsidiaries. Since internal capital markets tend to alleviate financial constraints to raise external funding, the expectation for the allocation of internal funds to favor the smaller members of conglomerates falls in line with our results. We further explore how efficiently internal capital funds are managed by multinational banks across their affiliates, that is, whether parent banks are more likely to allocate internal funds to their more profitable subsidiaries, as opposed to their less profitable ones. Our evidence falls on the "dark side" of the efficiency of internal capital market.

The contribution of this paper to the literature can be summarized as follows: first, we present robust evidence of the existence and operation of internal capital markets within multinational banks between the parent banks and their foreign affiliates. Second, we extend existing research to the effects of internal capital markets on the credit allocation of multinational banks to their foreign subsidiaries in developing and emerging economies.[2] Third, we provide evidence on how the parent banks of multinational banks allocate internal funds across their foreign subsidiaries. Our results support the argument that internal funds may not be allocated efficiently. Finally, we examine whether the impacts of internal capital markets depend on subsidiaries' capitalization and the host countries' monetary

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[1] Sources for raising external capital include issuing uninsured deposits and equity, for example.

[2] The research on internal capital markets within banks is still scarce, especially works which concentrate on the impacts of internal capital markets on the lending behavior of foreign bank subsidiaries located in developing countries. Most works examine the internal capital markets established by U.S. banks and their domestic subsidiaries (see Section 2).

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