

Multinational Banks and Supranational Supervision

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Multinational Banks

The case of Dexia:

- ▶ Multinational bank (MNB) with strong presence in France, Belgium and Luxembourg.
- ▶ Credit support by the 3 governments in 2008.
- ▶ CET1 capital becomes negative in 2011.
- ▶ Nationalization to avoid disorderly resolution.

Lessons drawn by academics and regulators:

- ▶ Risks of **fragmented supervision** and resolution.
- ▶ **Contagion** through MNBs (systemic risk).
- ▶ Strong rationale for a **common supervisor** (SSM).

What is the impact of centralized supervision **of multinational banks?**

Results

- ▶ Centralized supervision solves a **coordination problem**.
- ▶ Short-term effect: subsidiaries are better supervised.
- ▶ But MNBs now have **incentives to use branches rather than subsidiaries**.
- ▶ Long-term effect: MNBs **change their organizational form**.
- ▶ Impact of SSM on losses for the governments/deposit insurers:
 - ▶ Total losses decrease.
 - ▶ Redistribution of losses from foreign to home country.

Branch or Subsidiary?

Trade-off:

- ▶ Deposit insurance: **quality of the home vs. foreign DI** (e.g. Germany/Cyprus, Australia/New Zealand).
- ▶ Different transfers: **home unit not liable** for the foreign unit's losses with a subsidiary structure.
- ▶ Supervision: branch/subsidiary determines **who supervises the foreign unit** and the intensity of monitoring.

$t = 0$

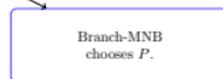
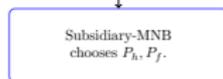
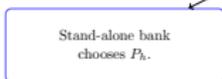


$\sigma = A$

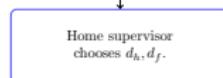
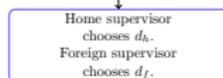
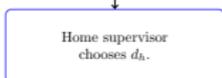
$\sigma = S$

$\sigma = B$

$t = 1$



$t = 2$

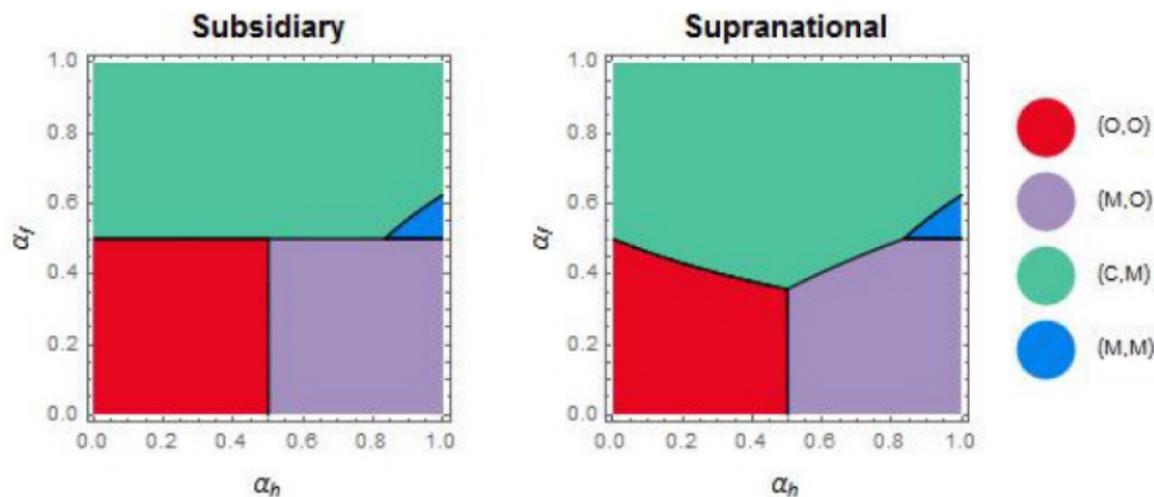


Supervision

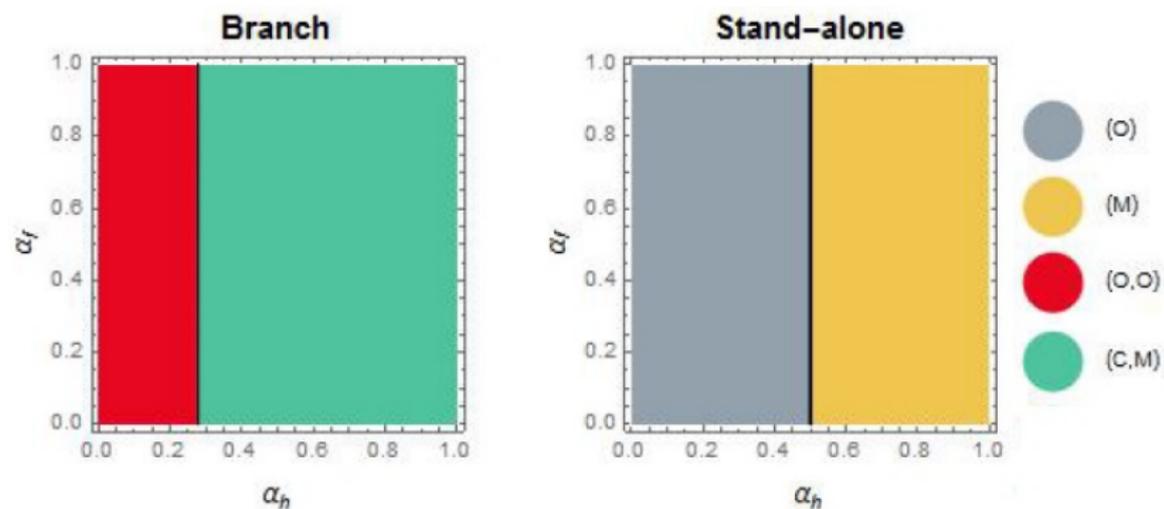
- ▶ Two decisions:
 - ▶ **Monitoring decision**: pay c in order to learn whether a unit's assets are good or bad.
 - ▶ **Prudential decision**: choose whether to force liquidation, after having observed the assets' quality or not.
- ▶ Objective function: minimize losses to the deposit insurance fund, that can repay with probability α_j .
- ▶ Possible strategies:
 - ▶ M : monitor the unit, close if assets are bad.
 - ▶ O : do not monitor and keep the unit open.
 - ▶ I : do not monitor and close the unit.
 - ▶ C : close the unit conditionally on the other unit's assets being good.

Optimal supervisory decisions - 2

- ▶ α_h : probability of a rescue in the home country.
- ▶ α_f : probability of a rescue in the foreign country.



Optimal supervisory decisions - 2



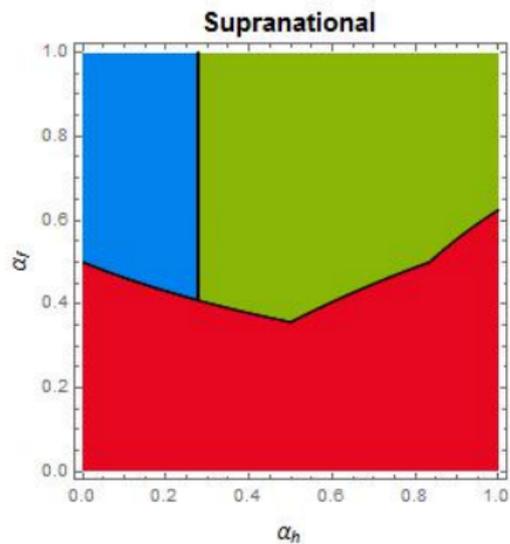
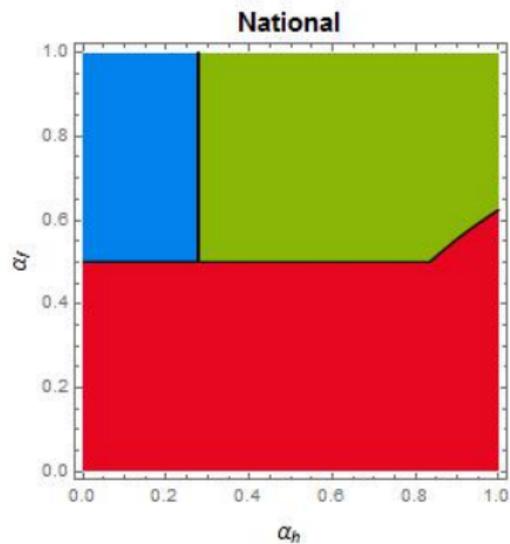
Internalization effect

- ▶ Monitoring in the foreign unit is useful for the home unit.
- ▶ There are situations in which:
 - ▶ Cost of monitoring higher than benefit for the foreign unit only.
 - ▶ Cost of monitoring lower than benefit for the foreign and the home units together.
- ▶ **National supervision** leads to too little monitoring of the foreign branch.
- ▶ **Supranational supervision** solves this problem and increases monitoring.

The representation choice

- ▶ The MNB will choose between three structures:
 - ▶ Subsidiary.
 - ▶ Branch.
 - ▶ Stand-alone.
- ▶ Takes into account all the subsequent decisions:
 - ▶ Different rescue probabilities.
 - ▶ Different supervision strategies.
- ▶ Supranational supervision affects the representation choice through the latter effect.

Optimal supervisory decisions - 2



Proposition

When supranational supervision changes the optimal representation form of the MNB, it induces the bank either to operate with a branch rather than a subsidiary, or to shut down a subsidiary unit to become a national (stand-alone) bank.

Policy implications

- ▶ Centralized supervision can be partly **offset in the long-run by changing the representation form of the MNB.**
- ▶ This always increases the costs to the home deposit insurer/government.
- ▶ However, **aggregate losses decrease.**
- ▶ Solutions:
 - ▶ Charge banks for using the subsidiary structure (implicit government subsidy).
 - ▶ Common deposit insurance does not have a clear impact.

Empirical implications

- ▶ In the short-run: supranational supervision makes it **more likely that the foreign unit is monitored**.
- ▶ Implications on how the **borrowing costs of the MNB** vary with monitoring, likelihood of rescue, national/supranational supervision, etc.
- ▶ In the long-run: supranational supervision **encourages branches over subsidiaries**, and can discourage cross-border expansion altogether.