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?
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.
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.
$t = 0$

MNB

$\sigma = A$

Stand-alone bank chooses $P_h$.

Subsidiary-MNB chooses $P_h, P_f$.

Branch-MNB chooses $P$.

$\sigma = S$

$\sigma = B$

Home supervisor chooses $d_h$.

Home supervisor chooses $d_h, d_f$.

Foreign supervisor chooses $d_f$.

Home supervisor chooses $d_h, d_f$. 

$\sigma = A$

$\sigma = S$

$\sigma = B$
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 $\alpha_i$.

- 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

- $\alpha_h$: probability of a rescue in the home country.
- $\alpha_f$: 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

[Graphs showing the relationship between \( \alpha_h \) and \( \alpha_n \) for national and supranational supervisory decisions.]
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.