Financial fragmentation

Too much of a good thing

Since 2008 global financial integration has gone into reverse

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IN 2005 ITALY’S UniCredit bought HVB, Germany’s second-largest lender, in what at the time was the continent’s biggest cross-border bank merger. At a stroke this gave UniCredit a commanding presence in Germany, Austria and Poland. It was widely hailed as a foretaste of deals to come thanks to Europe’s single currency. “We will become the first truly European bank,” declared Alessandro Profumo, UniCredit’s chief at the time. So it was something of a shock when in 2011 Germany’s bank regulator, BaFin, sought to limit the amount of cash UniCredit could transfer to its Italian parent, fearing that the German unit’s financial health might be compromised. This seemed to violate the spirit of free capital movement within Europe, and officials in Brussels complained.

Finance, the sector that globalised the most in the years leading up to the crisis, is threatening to go into reverse. Between 1990 and 2007 cross-border bank flows increased about tenfold, to around $5 trillion, according to the McKinsey Global Institute, the consultancy’s research arm. Last year the figure was less than a third of that. The decline extended across all regions, though Europe suffered most.

This has happened for two reasons. The first is the banks’ own efforts to deleverage, either to shed money-losing operations and assets or to meet stiffer capital requirements. The second is the realisation that cross-border banks were an important channel for transmitting the mortgage crisis in America and the sovereign-debt crisis in peripheral Europe to other countries. To limit such spillovers and save taxpayers having to bail banks out of their foreign misadventures, regulators around the world are seeking to ring-fence their banking systems.

The case for integration

Before the crisis, the logic of financial globalisation seemed impeccable. Businesses were increasingly operating across borders and needed banks that could travel with them. America and Britain, which excelled at finance, were anxious to market their expertise abroad. A more integrated global economy also needed a financial system to funnel capital from countries with a surplus of savings to those with a surplus of investment opportunities. Banks had long played that role within countries, taking in deposits in one market and deploying them in another. It made sense to do the same thing across borders.

Recipients of such flows benefited in other ways, too. More efficient foreign banks could force local ones to raise their game. That was why China, for example, listed its state-owned banks on stock exchanges and permitted foreigners to hold minority stakes. In short order Goldman Sachs, Bank of America, UBS and Royal Bank of Scotland took up the offer, though some of them have since sold stakes.
In Europe the logic was especially powerful. The benefits of a single currency strongly suggested that there should be a single banking market as well, so that the interest rates which businesses and households paid were determined by the European Central Bank (ECB), not the relative health of their local banks.

Financial globalisation did just what it was meant to, perhaps a little too well. Cross-border bank flows expanded enormously between 2000 and 2007, with 80% of the increase coming from Europe, according to McKinsey. Those flows enabled debtor countries such as America, Spain and Greece to finance housing booms and government deficits without paying punitive interest rates. But a large part of those flows reflected banks’ own leverage as they both borrowed and lent heavily abroad.

Tellingly, the event that touched off the crisis in the summer of 2007 was an announcement by France’s BNP Paribas that it was suspending redemptions to an investment fund heavily invested in American mortgage securities. Eventually a number of banks across Europe needed government bailouts because of losses sustained on mortgages in America and elsewhere.

The cost of bailing domestic banks out of foreign misadventures exposed one risk of financial globalisation; the losses sustained by domestic creditors and savers when foreign banks went bust showed up another. In 2008, when Landsbanki, an Icelandic bank, went bust, British and Dutch depositors had to be bailed out by their own governments because Iceland would guarantee only Icelandic deposits. Sir Mervyn King, the former governor of the Bank of England, famously commented that “global banks are international in life but national in death.”

Regulators around the world, working through the Financial Stability Board, an international committee of central bankers, regulators and finance ministers, have since tried to reduce the threat of a big bank collapse and the need for a bailout, but many of these efforts have undermined banks’ incentive and ability to do business across borders. For example, domestic regulators used to allow foreign banks to rely on the capital, liquidity and regulatory oversight of the foreign parent. Now many of them are pressing units of foreign banks, and foreign units of domestic banks, to maintain sufficient liquidity and capital independent of the parent, sometimes by organising themselves as subsidiaries rather than branches.

In America the Federal Reserve will soon require foreign banks above a certain size to collect all their local units into a single, separately capitalised holding company that meets the same capital and liquidity requirements as American banks do. Until now the Fed has relied on foreign regulators to ensure that the parent bank can support its units in America. The proposal has prompted a flurry of opposition.

Nor is it just banks that have to abide by tighter rules. America’s Commodity Futures Trading Commission (CFTC) has ruled that anyone trading swaps with an American bank’s foreign unit must generally go through a central clearing house. Gary Gensler, the CFTC’s chairman, rattles off a litany of financial disasters involving offshore affiliates: AIG had run its derivatives out of London; Lehman’s London affiliate had 130,000 outstanding swaps contracts, many guaranteed by its American parent; Citigroup had set up many off-balance-sheet vehicles in the Cayman Islands; and JPMorgan Chase earlier this year suffered huge losses on trades in London. “Risk...comes crashing back to our shores from overseas when a run starts in any part of a modern, global financial institution,” says Mr Gensler.

The CFTC has agreed to exempt foreign swaps customers that operate under similar rules abroad, and the Fed has yet to issue its final foreign banking rule. But for the most part American regulators, like their counterparts overseas, have stuck to their guns. “We will not let the pursuit of international consistency force us to lower our standards,” said Jack Lew, the Treasury Secretary, in July.

Even when regulatory initiatives are not explicitly discriminatory, they make cross-border banking harder. Benoît Coeuré, a member of the ECB’s governing board, notes that Basel 3, a set of new international capital and liquidity standards for banks, is being implemented differently across countries: capital is measured differently under American and international accounting rules, and even within Europe, Britain, France and Germany have proposed different bank holding-company structures. “If you have an idiosyncratic local legal environment, then market participants will find it safer just to play on their home turf because of the legal uncertainty that goes with international activities, and we’ll lose the benefit of international financial integration,” he says.
Such changes have undermined the case for global banks. Huw van Steenis at Morgan Stanley comments that “if I’m a German bank, one of my edges is I have really cheap funding in Germany because I have more deposits than loans. If that advantage goes away, one of their unique selling points goes, too.” Morgan Stanley estimates that banks’ cross-border claims within the euro zone have fallen from nearly $4 trillion in mid-2008 to about half that amount now.

And regulation is only one factor at work. Another is the need to deleverage in order to shore up capital and meet higher capital requirements. Again, this is most apparent in Europe, where banks have been shedding loans and bonds in troubled peripheral economies. Non-residents have gone from holding 43% of Spain’s and Italy’s sovereign debt in 2010 to 35% now. American money-market funds have cut their exposure in Europe by 60% since 2010.

In some countries regulators have quietly pressed banks to increase domestic lending to boost their economies, at the expense of foreign operations. In others they have been more explicit. Britain’s Funding for Lending scheme, launched in 2012, offers banks cheap central-bank financing for increasing lending to British households. America’s Volcker rule would exempt that country’s debt, but not that of other sovereigns, from restrictions on banks’ proprietary trading.

In retrospect, much of the rise in cross-border lending was foolish. It made both European and American banks more vulnerable to a sudden drop in asset prices and increased the risk of a credit crunch. McKinsey’s work shows that cross-border bank lending is far more volatile than other capital flows such as bonds, equities and direct investment. Research by the Bank of England shows that over the past decade lending by foreign banks was far more cyclical than by domestic banks.

Less financial globalisation should also reduce the risk that contagion from one country’s banking problems will cause economic damage elsewhere. That is the lesson of the Asian banking crisis of 1997-98. In many countries loans in 1997 exceeded deposits by 20%, says Mr van Steenis, with the gap made up by wholesale funding, often from abroad. When that funding disappeared, many banks teetered on the verge of collapse, prompting the authorities in the countries concerned to put a cap on the use of such funding. This had the positive effect that Asian banks suffered very little contagion from either the American mortgage crisis or the European sovereign-debt crisis.

The penalties of self-reliance

But reduced cross-border links come at a price. If a country suffers a domestic shock, it will have to bear more of the consequences itself. Although regulators fret over shocks to a bank’s foreign parent or withdrawal of that parent’s support, Peter Sands, the boss of Standard Chartered, a British bank, observes that “there are lots of examples of shocks in the market when the support of the parent is needed.” International banks provided vital funding to South Korea during its crisis in 1997 and to Dubai in 2009 when a state-owned developer almost defaulted. “International flows of funds in the banking system can be a source of contagion but also of resilience,” says Mr Sands.

Financial fragmentation also challenges one of the great promises of globalisation: that savings-poor countries will be able to find the wherewithal to finance essential investment by borrowing abroad. In theory, if capital is free to seek the highest potential return, domestic saving and investment should not be correlated. In 1980 Martin Feldstein and Charles Horioka documented that in fact they are, suggesting that national borders were impeding the free flow of capital. Over the years that correlation diminished, particularly within Europe, but Mr Coeure points out that it has now returned.

The result is starkest in Europe, where Spanish and Italian businesses are obliged to pay 80-160 basis points more than German ones to borrow. This is because of the higher rates on sovereign debt in those countries and fewer deposits from healthier countries. A more balkanised financial market makes it less likely that German savers will finance dodgy Spanish loans. But it also makes it more likely that they will finance low-yielding German loans, sending high-yielding Spanish businesses away empty-handed.

In addition, financial fragmentation means less competition for often cosseted domestic banks from nimble foreign rivals. Studies of foreign banks entering Australia, Indonesia, the Philippines and Colombia found that they reduced interest-rate spreads and made domestic banks more efficient (although sometimes also more likely to make bad loans).
The best way to maintain financial globalisation without fear of shoddy regulation spilling over from one country to another would be increased co-operation among regulators. This is beginning to happen at the Financial Stability Board, which is trying to ensure uniform implementation of new capital and liquidity standards across most countries and has been pushing for a European banking union.

Unfortunately this process has exposed divisions. America’s biggest banks, for instance, will have to maintain a higher leverage ratio (a type of capital requirement) than stipulated by Basel 3. And although a single European supervisor will replace national regulators for the euro zone’s biggest banks next year, prospects for a common deposit insurance and resolution regime remain uncertain, for much the same reason that has made the entire crisis so intractable: creditor nations such as Germany, Finland and the Netherlands are deeply reluctant to make their taxpayers foot the bill for bank failures in debtor countries.

It seems unlikely, then, that banks will return to the highly globalised state of 2007 soon. But if cross-border lending remains subdued, that will put added pressure on capital markets to make up the difference—and they, too, are feeling the pinch.

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