

MULTINATIONAL BANKING AND GLOBAL CAPITAL MARKETS

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Summary

Multinational banking encompasses a variety of activities, including trading in currencies, borrowing and lending, and financing international trade. These activities are delivered via a variety of organizational forms. The multinational bank exists for a number of reasons, including to follow clients and because it has advantages in producing certain products. International financing has grown rapidly over the past decade, with the main centers of international finance being the United Kingdom and the United States. The main currency of activity is the US dollar.

The international debt markets, particularly the Euromarkets, provide the main focus of cross-border financing. The Euromarket's main center of activity is the United Kingdom, followed by the United States. While a number of historical factors have led to the development of the Euromarkets, many of these factors are no longer relevant to the modern marketplace. The Euromarket continues to exist due its ability to offer efficient delivery of financial services relatively free of regulation-driven distortions. The continued growth of the Euromarket is fuelled by its ability to offer a range of products tailored to particular financing needs, and by its ability to provide continuous product innovation. In addition to the debt funding provided by the Euromarket, debt financing via the foreign bond market, particularly in Swiss Francs, is also available. International equity funding via cross-border listing of shares is also possible.

The nature of international financing undergoes continuous change. These changes are due to factors such as deregulation of various national financial systems, product innovation, and increased participation by non-traditional providers of financial services. There has also been a growing move toward the use of direct rather than intermediated finance by increasingly cost-conscious users. Within this environment,

the recommendations of the Bank for International Settlements (BIS) has come to play a central role in setting the benchmarks for regulatory practices.

1. Globalization of the International Financial System

1.1. Multinational Banking: A Brief Taxonomy

The provision of financial services across-borders has a long history, with trade finance going back to the Phoenicians (c.1000 BC). Consideration of this early period demonstrates the importance of trading relationships in creating a demand for trade finance. However, there have been two distinct waves of growth of modern multinational banking. The first of these waves occurred before World War I and was particularly distinguished by the growth of British overseas banks. The second wave of multinational banking occurred in the 1960s and was led by the expansion offshore of American commercial banks. This second wave of multinational banking also saw a widening of the range and scope of products offered by multinational banks. Today these activities include:

- (a) Dealing in foreign currencies, derivative securities, gold, and precious metals
- (b) Participating in the Euromarket
- (c) Borrowing and lending in foreign currencies
- (d) Provision of trade finance
- (e) Trading in foreign securities markets
- (f) Provision of corporate finance across-borders

This list of services includes activities that are also performed by non-multinational banks. One such activity is foreign currency trading. A multinational bank has been defined as “a bank that owns and controls banking activity in two or more countries.” However, some authors have used narrower definitions of multinational banking in order to distinguish between international banking and multinational banking. The problem with the first definition is that it can be interpreted to include banking activity that does not require a physical offshore presence. An example of this can be drawn from the Euromarkets. It is relatively easy for a bank to participate in Euromarket loans, and fund these loans in offshore markets, without establishing a physical presence offshore. A similar situation exists in the areas of trade finance and foreign exchange trading. Such a bank would be considered international, but not multinational. This illustrates the taxonomic issues raised when considering multinational banking.

International banking can be considered to encompass two activities. The first of these, traditional foreign banking, is the provision of transactions in the home currency to non-residents. These transactions are provided by both domestic and foreign owned banks which are located in the host nation. The second activity can be called onshore Eurobanking. Here banks participate in Eurobanking without departing their home market. Offshore banking can be considered part of international banking, rather than as a separate category. Offshore banking is the provision of banking services in foreign currencies, again without departing the bank’s home base. This type of activity includes some types of trade finance and foreign exchange trading. Multinational banking is distinguished from international banking by the physical location of the activity. In

particular, multinational banking is distinguished by banks having a physical presence that engages in the provision of banking services from a location outside the country of first incorporation of the parent bank. It is the requirement for a physical presence that develops this definition beyond that offered by the first definition. This definition includes activities, in particular some types of Euromarket activity and some types of trade financing, as discussed above, that are in a foreign country and are owned and controlled by a bank, but do not require a physical presence in a foreign country. As such these activities are examples of international banking rather than multinational banking. However, under the framework provided by the first definition, these activities would be classified as multinational banking.

1.2. Organizational Structures in Multinational and International Banking

When establishing a physical presence in an offshore market, a bank can choose from a range of possible organizational structures. Each of these structures offers different combinations of advantages and disadvantages, some of which will depend on the particular host nation regulations. In some nations certain organizational structures may be prohibited.

1.2.1. Correspondent Banking

Correspondent banks act to clear transactions between banks. These relationships enable banks to meet the requirements of domestic customers' foreign exchange and trade dealings. The domestic bank appoints a foreign bank to act as its agent for transactions in that foreign country. Correspondent banking has the advantage of being a relatively low cost method of accessing a market, particularly a market where establishment costs are large or regulatory barriers to entry are high. By engaging in international correspondent banking, the domestic bank has low cost access to the expertise of the foreign bank's corporate and international departments, without the cost of establishing a physical presence offshore.

1.2.2. Representative Offices

A representative office is a small office in the host nation that coordinates a bank's correspondent banking relationships and renders assistance to the bank's existing customers. The office often has a secondary role of disseminating information about the parent bank and collecting information about the host country. Representative offices cannot raise liabilities or create assets; instead, they seek out information about the host environment to determine if profitable business opportunities. Representative offices are often used to coordinate matters relating to correspondent relationships such as check clearance, trade transactions, and foreign exchange matters. Representative offices can be run on relatively low budgets and as a result can be easily opened and closed.

1.2.3. Agencies

Agencies provide advantages over representative offices in that they can conduct transactions. The activities permitted to agencies vary according to host country laws, with some nations prohibiting agency activity by multinational banks. The usual

limitation on an agency is that it cannot raise or solicit deposits. Exceptions do exist in that some countries allow agencies to accept credit balances from residents that are linked to a specified purpose. Such credit balances usually have other limitations as to length of time and terms of access.

1.2.4. Consortium Banks

A consortium bank can be considered as a joint venture bank separately incorporated and owned by two or more shareholders who are themselves banks, usually of different nationalities. Consortium banking is often the only possible method for small and medium sized banks to access the Euromarkets. The consortium bank enables capital and expertise to be pooled to the mutual advantage of the participants. Some consortium banks are formed to service a particular market segment, such as cross-border mergers and acquisitions or project finance. Another reason for the establishment of a consortium bank may be to access a particular geographic market. Some nations have banking regulations that require host country participation and as a result a consortium structure may be appropriate.

1.2.5. Merchant Bank Subsidiaries

A merchant bank subsidiary is a merchant (investment) bank that is wholly owned by a bank located in another country. It offers a method of entering a host country without the constraints that may be imposed on a full banking entry. Such a subsidiary would offer the full range of wholesale services but would be disadvantaged by lower credit ratings than would be the case with a full banking license. This lower credit is due to the perception that merchant bank subsidiaries are not subject to the same level of prudential supervision.

1.2.6. Edge Act Corporations

Edge Act Corporations are an organizational structure unique to the United States. The Edge Act (an amendment of Section 25 of the US Federal Reserve Act) allows US banks and foreign banks to conduct international banking and finance activities in states outside their state of incorporation in the United States. Edge Act corporations can conduct a wide range of banking activities including accepting liabilities other than savings deposits, financing international trade, and making loans. These activities must be related to international transactions.

1.2.7. Bank Branches

A foreign bank branch is a branch located in a different country from the country of incorporation of the parent bank, without the branch itself having separate incorporation. As such, the branch is integral to the parent and is not separately capitalized. The branch will carry on banking business, subject to the laws of the host nation. The restrictions imposed on foreign branches are such that they usually have the ability to offer a nearly comprehensive range of banking services, with restrictions on access to the retail market being usual. As the branch is not legally separate from the parent, it has access to the full support, credit rating, and capital base of the parent.

1.2.8. Bank Subsidiaries

A bank subsidiary is a separately incorporated bank that is controlled by a parent located in another country. Such subsidiaries are generally wholly owned, as this reduces potential problems associated with dissenting minority shareholders. The host nation regulations imposed on foreign bank subsidiaries often determine whether this organizational structure is chosen. Generally, as discussed above, multinational banks prefer the bank branch structure to the bank subsidiary structure. However, in some cases, the host nation regulator will not permit foreign bank branches to be established, mainly due to concerns regarding prudential regulation.

1.3 Reasons for Expansion Offshore by Multinational Banks

A number of reasons have been advanced to explain why banks expand offshore. The most frequently discussed idea is that banks expand offshore in order to follow their clients. This is usually characterized as defensive expansion. This approach argues that banks must follow their clients abroad in order to retain (defend) their bank--client relationship. If the bank does not follow its clients abroad, the client will establish a new banking relationship in the host nation. This new banking relationship could expand to supplant the bank--client relationship in the host nation. The defensive expansion relationship could reflect either foreign direct investment (FDI) or trade relationships, or both.

As discussed in the previous section, host nation regulations will in most cases determine the organizational structure adopted by a multinational bank in the host nation. Likewise, regulation can act to encourage international and multinational banking in general, and act to determine the location choice when expanding offshore. Domestic regulation has acted to encourage offshore banking as a means of escaping the impact of restrictive home nation regulation. Likewise, less restrictive host nation regulations will attract foreign banks to that location.

In line with the Hymer–Kindleberger Theory, it is argued that entrants to a foreign market must possess some special advantage if they are to overcome domestic banks' home-territory advantage. It has been argued that the Hymer–Kindleberger approach is best applied to multinational banking within the framework provided by internalization theory. Consistent with this general framework, banks from developed financial markets have skills and expertise that can be applied to overseas markets at relatively low marginal costs. Owing to market failure, these banks are unable to sell these skills, and so must expand offshore in order to reap the maximum returns from this advantage.

Other examples of firm specific advantages that provide an impetus for offshore expansion include comparative advantage in the production of bank products, parent size, and international experience. Comparative advantages in multinational banking are considered in terms of lower cost of capital, lower interest costs, and lower non-interest costs. Banks with lower costs of capital have the ability to provide bank products (deposits and loans) at a lower cost than their competitors. Due to difficulties in accurately calculating the cost of capital for multinational banks from publicly available data, the focus of comparative approaches to multinational banking has been on interest

costs and non-interest costs. In general, the comparative advantage approach to multinational banking is consistent with the traditional Heckscher–Ohlin trade theory.

The parent size and capital base approaches to multinational banking are based on the observation that size and multinationality are frequently related. The causal relationship between size and multinationality is not clear, although the size of a bank's capital base is considered to be one of the determinants of international competitive success. A problem is that parent size and capital base have been found to be highly correlated with other measures of multinationality and of international experience. As a result, it is not clear which aspect of the multinational bank parent size represents. Within the framework provided by internalization theory, the firm-client relationship (defensive expansion), comparative advantages, and parent size (capital base) are firm characteristics that cannot be sold, due to market failure. Thus, the multinational bank will expand offshore and create an internal market in place of the external one. The effect of this is to internalize the impact of external market failure to the advantage of the multinational bank, by minimizing transaction costs.

While firm characteristics explain which banks become multinational, defensive expansion theory does not provide a complete explanation of the locations chosen by multinational banks for offshore expansion. The internalization approach to multinational banking retains the assumption of profit maximization; thus the multinational bank will seek to expand to those locations that offer the greatest profit opportunities. A disincentive for offshore expansion is the level of competition in the host market. The more active the incumbent banks, the less opportunities multinational banks have to establish their operations. The degree of activity or incumbency of the host nation can be measured by the level of market concentration or by the level of domestic deposits. In general, the greater the level of incumbency, the fewer the opportunities for multinational banks to establish a successful *ab initio* presence.

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Biographical Sketch

Barry Williams is Associate Professor of Finance at the School of Business, Bond University, Queensland, Australia. He has held teaching positions at a number of Australian Universities. Prior to commencing his academic career, he worked in the Economics department of a major Australian bank. His research focuses on the behavior of foreign banks in Australia, and he has published articles on this topic in several international journals.