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# Cross-border banking and credit (mis)allocation

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# Overview

The paper deals with two research topics:

- diverging preferences of shareholders and regulators/supervisors about portfolio diversification and capital structure in cross-border banking
- the great mortgaging

The paper establishes a causal link between the banks' propensity to diversify abroad (in low correlated sectors) and the growing trend in mortgage lending.

The paper discusses policy alternatives to address the issue of credit misallocation caused by cross-border banking.

# Choice variables for cross-border banking

## Capital structure:

- foreign branch or foreign asset purchase
- subsidiary under full ownership or with minority investors

## Portfolio allocation between four types of asset

	Domestic country	Foreign country
Tradable sector		
Non-tradable sector		

The bank chooses the portfolio that maximises the Sharpe ratio s.t.

- default probability  $< 1\%$
- leverage  $E/A > 5\%$
- foreign assets  $< 25\%$  of total assets or subsidiary equity  $< 25\%$  of total equity

# Simulation results

Diverging preferences about portfolio and capital structure :

- The domestic portfolio is balanced between tradable and non-tradable sectors.
- To enhance diversification, the foreign portfolio is biased towards the non-tradable sector.
- Domestic regulator would prefer an unbalanced foreign portfolio; foreign regulator would prefer a balanced foreign portfolio.
- Bank shareholders as well as foreign regulator would prefer a foreign branch; domestic bank regulator would prefer a foreign subsidiary.

# Policy implications

## Cross-border banking might

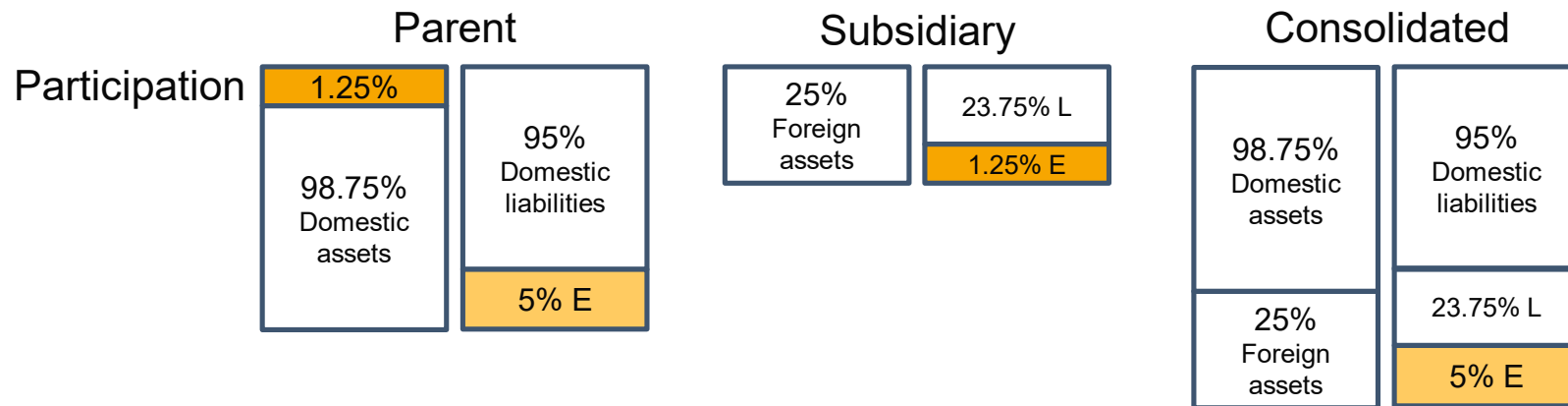
- increase systemic risk (concentration in mortgage lending) and the potential credit misallocation.
- change the interest rate pass-through and the effect of monetary policy on GDP components.
- require greater coordination in bank supervision and in deposit guarantee schemes (banking union) to address diverging preferences.

# Overall assessment

- + The paper proposes a stimulating and challenging hypothesis about the effect of cross-border banking on credit allocation and risk concentration.
- + The paper is well written and the economic intuition well developed.
- Model simulations could be explained more extensively; the robustness of the effect of capital structure could be checked.
- The hypothesis of a causal link between cross-border banking and the great mortgaging could be tested empirically.

# Comments on model simulations

- Restrictions in portfolio optimisation seem to never be binding. Why?
- In the case of subsidiary, does the 5% leverage ratio apply to the consolidated balance sheet or to the parent and subsidiary separately?



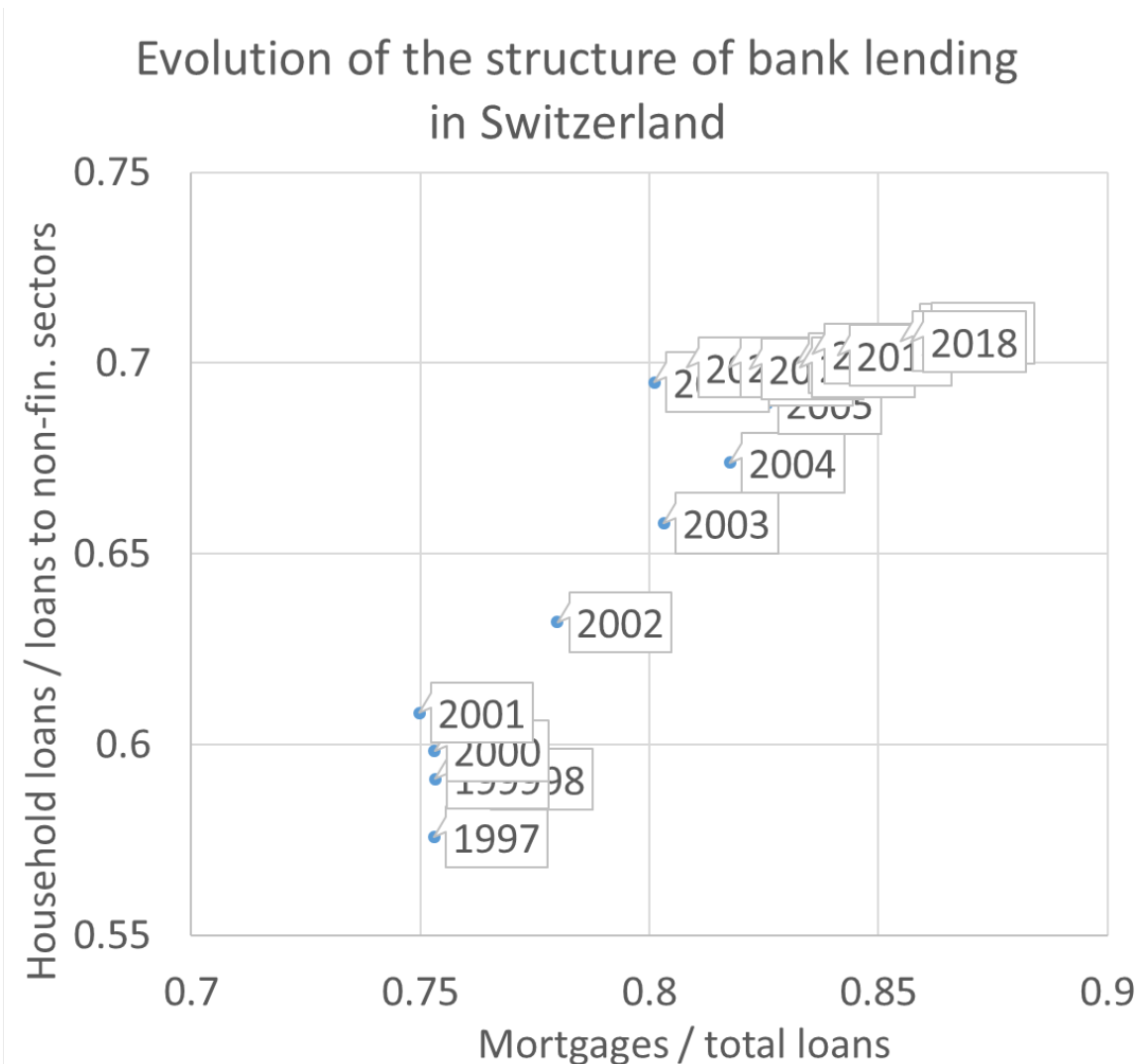
- Robustness check: how does the shareholders' and regulators' preference between branch vs. subsidiary change with the ratio of foreign/domestic assets and with the relative size of the economy.
- Krainer (2017), *Journal of Financial Stability*, No. 31, pp. 107-118.

# Comments on the causal link between cross-border banking and the great mortgaging

- Empirical analysis could easily test the relationship between cross-border banking and mortgage lending:
  - Do foreign banks grant more mortgage loans than domestic banks?
  - Is mortgage lending stronger in countries where foreign banks are more active?
- Causal observation from Switzerland would however reject the hypothesis:
  - Strong increase in mortgage lending over the past decades
  - Increase mainly driven by domestic banks; foreign banks hold only 2.6% of bank mortgages and 10.8% of other loans.
- Policy recommendations could be formulated more explicitly. How would a banking union or international coordination solve the problem? What would be the solution?



# The great mortgaging in Switzerland



Foreign branches or foreign-owned banks in Switzerland hold only 2.6% of bank mortgages (and 10.8% of other loans).