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THOUGHT LEADERSHIP BRIEF

KEY POINTS

- Restrictive home-country regulations lead to less transparency of banks' foreign subsidiaries and exert negative externalities on the global banking system.
- Our finding that negative externalities primarily exist in countries with weak supervisory power highlights the importance of bank supervision when regulators consider using lax regulations to attract foreign capital.
- Our results highlight the importance of monitoring the disclosure practices among banks' foreign subsidiaries.

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Uneven Regulatory Playing Field and Bank Transparency Abroad

Tai-yuan Chen

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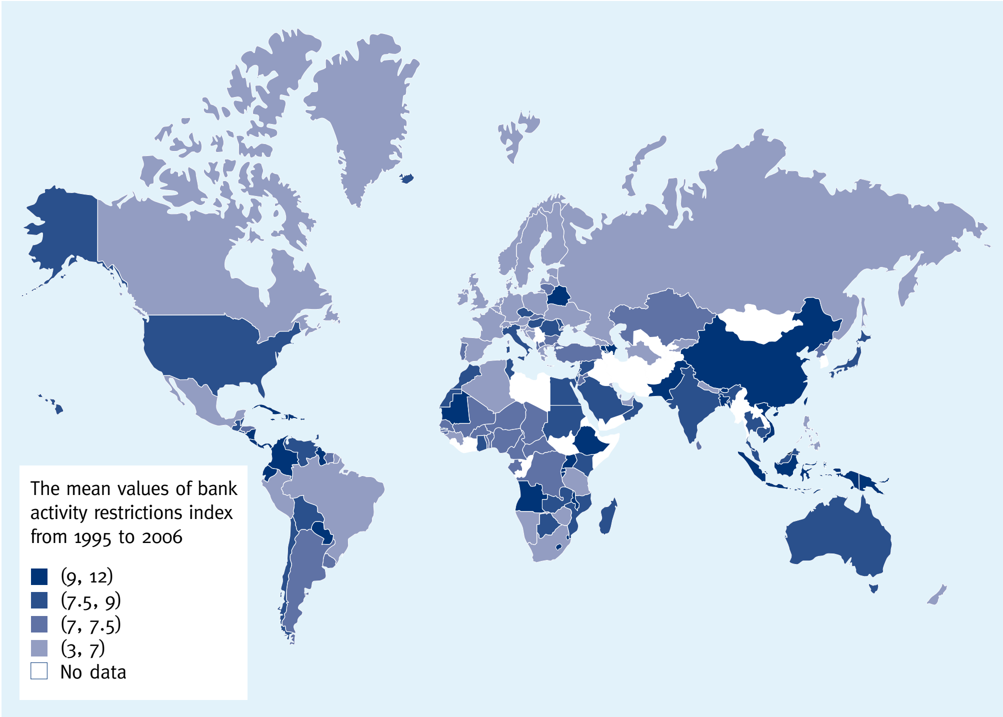
Issue

Cross-border banking claims have reached more than half of global GDP and the vast majority of these claims are held by systemically important financial institutions with operations worldwide. While the global banking network increases risk sharing, it also serves as a channel for shock propagation and therefore exacerbates the risk of contagion. Although bank regulators have made great efforts to intensify international collaboration, bank regulations still vary widely across countries (Figure 1).

Figure 1: Bank Regulations Vary Around the World



Date source: Barth, Caprio, and Levine (2013), with higher values indicating tighter activity restrictions.

Prior academic studies document that regulatory inconsistency affects bank flows and risk-taking activities abroad, but several important questions remain unanswered. Do cross-country differences in bank regulations affect banks' financial reporting transparency abroad? If so, how? What is the impact of reporting transparency on bank instability abroad?

Assessment

We hypothesize that foreign subsidiaries' transparency declines when their home countries (domestic markets) have tighter activity restrictions than their host countries (foreign markets). One reason is that opacity weakens market discipline on banks' risk-shifting behavior. High leverage combined with explicit and implicit government support creates incentives for banks to take on overly risky projects that benefit shareholders at the expense of debtholders. Because foreign subsidiaries are subject to host-country regulations, foreign subsidiaries in countries with lax regulations offer parent banks opportunities to take on overly risky projects. By engaging in risky, negative net present value projects, bank managers benefit shareholders at the expense of debtholders. To protect their interests, stakeholders (e.g., depositors, creditors, and regulators) in the home and host countries have incentives to monitor banks' risk- taking behaviors. While subsidiaries are separately capitalized, stakeholders in the home countries are nonetheless vulnerable to subsidiaries' downside risk because parent banks are expected to support their troubled subsidiaries. In addition, parent banks also bear downside risk through channels such as reputational contagion and fire sales of the failed foreign subsidiary. Collectively, if firms shift risks in response to regulatory differences, parent banks have an incentive to reduce transparency of their foreign subsidiaries when home countries have tighter restrictions than the host countries. Parent banks may also reduce transparency of foreign subsidiaries because of proprietary costs. Prior literature suggests that banks pursue more profitable opportunities in countries with less constrained regulations by acquiring foreign banks. Because information disclosures can deprive banks of their competitive advantage, banks may reduce disclosures to maintain their competitive advantage and deter the entrance of potential competitors.

We test our first hypothesis using data from a sample of 1,140 subsidiary-years of 250 majority-owned foreign subsidiaries located in 39 host countries (owned by 166 parent banks in 40 home countries) from 1995 to 2006. Consistent with our first hypothesis, we find that differences in regulatory restrictiveness between home and host countries is negatively associated with foreign subsidiaries' disclosures, which reduces foreign subsidiaries' transparency. For a typical bank, a one standard deviation increase in the measure of regulatory differences between home and host countries decreases the probability of disclosing four key pieces of information related to lending and securities activities by 10.68% to 7.07%.

Additional analysis suggests that risk-shifting incentives, rather than proprietary cost considerations i.e., the desire to reveal information that will help competitors, are the most likely mechanism through which regulatory differences affect foreign subsidiaries' transparency. To examine the role of such incentives, we perform analyses conditional on parent banks' capital ratio and host country's supervisory power. To examine the role of proprietary costs, we perform analyses conditional on profitability, a common proxy for proprietary costs. We perform the analyses by partitioning our sample based on the sample medians of variables of interest. Our empirical findings indicate that parent banks' low capital ratios and weak host-country supervisory power, but not foreign subsidiary's high profitability, increase the negative effect of regulatory differences on foreign subsidiaries' transparency.

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Our second hypothesis is that foreign subsidiaries with greater transparency are less likely to suffer from financial instability. This is because transparency decreases banks' ability to conceal risk exposure and so reduces investors' uncertainty about banks' intrinsic value, thereby reducing banks' vulnerability to downside risk. In addition, because bank transparency facilitates market discipline, the improved market signals such as stock market reactions can prompt regulatory interventions and reduce financial instability.

We test our second hypothesis by examining the experience of foreign subsidiaries during the 2007-2009 global financial crisis. Specifically, we assess the effect of pre-crisis disclosure levels on the crisis-period financial strength for the 145 foreign subsidiaries that existed in 2006. Consistent with our prediction, we find that foreign subsidiaries with less disclosure are more likely to fail or experience large deposit withdrawals during the crisis, which implies that foreign subsidiaries' diminished transparency exacerbates financial instability.

Recommendations

Overall, our research complements earlier studies by focusing on banks' foreign subsidiaries and studying the effect of regulatory inconsistency. The evidence suggests that regulatory inconsistency leads to degraded transparency abroad, which in turn exacerbates financial instability in the local market. Our finding that the negative externalities primarily exist in countries with weak supervisory power highlights the importance of bank supervision when regulators consider using lax regulations to attract foreign capital.

Banks often evade costly regulations in their home countries by pursuing opportunities abroad. We provide evidence on the cost of such regulatory arbitrage. Thus, tighter home-country regulations may reduce the transparency of banks' foreign subsidiaries.

Bank failures and bank runs are often contagious and can lead to the meltdown of financial systems. Given that financial systems are increasingly interconnected across countries, the failure of foreign subsidiaries may amplify risk contagions and shock transmission beyond the local market. Thus, our analysis also provides policy implications for regulators worldwide regarding the importance of disclosure practices among banks' foreign subsidiaries.

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