Government Intervention Reduces Banking Globalization

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Following the financial crisis of 2007-2009, cross-border bank lending has slowed significantly, and non-bank intermediation has risen to fill this gap. Is this the result of new frictions in the global banking system? This column presents evidence that government interventions have reduced the global activities of individual banks along three dimensions: depth, breadth and persistence. Following nationalization, non-British banks allocate their lending away from the UK and rely more on external funding, reducing the depth of banking globalization. Second, banks' cross-country asset allocations converge following nationalization; lowering the breadth of bankingl globalization. Third, evidence from US TARP supports the notion that these effects might not persist after the intervention is unwound. We interpret this as evidence of financial protectionism: bank nationalization reduces financial globalization.

International financial intermediation has changed significantly since the 2007-2009 global financial crisis: portfolio flows have taken up the slack left by the collapse in bank lending.[1] Several reasons have been proposed for this development, including a) a rise in bank regulation, b) weakness in loan demand, and c) political interference in banking as a result of government intervention.[2] In this column, we discuss the last explanation.

Government intervention may affect the *depth* of banking globalization. On the asset side of a bank's balance sheet, a disproportionate reduction in cross-border lending following nationalization constitutes *prima facie* evidence of a negative impact on banking globalization, referred to as "financial protectionism" by Rose and Wieladek (2014). As part of government support, banks were often asked to increase domestic lending.[3] That is, the "home bias" exhibited by many (see, Cerutti and Claessens, 2014; Cerutti, Claessens and Ratnovski, 2014, De Haas and Van Horen, 2012; Giannetti and Laeven, 2012; Presbetero, Udell and Zazarro, 2014, Forbes, Reinhardt and Wieladek, 2016) would be exacerbated if the bank received a large public intervention, because of the natural preference of a regulator or government towards domestic lending. Furthermore, this effect would be even more pronounced in a crisis, especially when there is a credit crunch as banks face competing demands from regulators and funding constraints (Cerutti and Claessens, 2014).

But the "depth" effect need not impact only the asset side of the balance sheet. In a crisis, nationalized banks are also perceived to be the safest home for deposits, as they are owned and backed by the government. Unsurprisingly, Berger and Roman (2015) find that the US Troubled Assets Relief Program (TARP) gave participating institutions a competitive advantage in raising deposits, mainly because those banks were perceived to be safer. Similarly, Acharya and Mora (2015) document a "flight to safety" effect showing that previously liquidity-constrained banks experienced an increase in deposits following the introduction of TARP. This suggests that government intervention may skew bank liabilities toward domestic deposits.

Large banks usually lend and borrow in many different foreign countries. The asset mix across countries differs by bank, often depending on the particular regional or industrial expertise of the bank. For example, Standard Chartered is a large UK bank whose lending is primarily focused on Asia; and Santander, a Spanish bank with substantial operations in Latin America, is now the third largest mortgage lender in the UK. If the authorities impose national political preferences on nationalized banks, leading to a reduction in lending to a particular set of countries, then nationalized banks from different countries would have increasingly divergent asset portfolios. However, nationalized banks from the same country would be expected to have more *similar* asset portfolios. Does the data support this idea? .

Are these effects persistent? US banks provide an insight. Unlike banks in other countries that received public support during the global financial crisis, most American banks have now repaid the funds they received through TARP. Bias against foreign lending could either persist or disappear following TARP exit.

In a recent paper, (Kleymenova, Rose and Wieladek, 2016), we provide empirical evidence along these three dimensions. Using UK data, we document that following nationalization non-British banks allocate their lending away from the UK and increase their external funding (depth). In addition, banks' cross-country asset allocations converge following nationalization (breadth). Finally, using US TARP data we show that these effects might not persist after the intervention is unwound (persistence).

The Depth Effect: British Bank Assets and Liabilities

Given the presence of a large number of domestic and foreign banks that engage in significant cross-border lending, the UK banking system is an ideal place to investigate whether government interventions affected lending and funding (depth) of banks operating in the UK. Using quarterly data from the Bank of England, we document a permanent effect of foreign bank nationalization as a decrease in the mix of foreign assets in total assets by around 15%. This is an economically significant amount, comparable to those of Rose and Wieladek (2014), and is consistent with the hypothesis that government intervention reduces banking globalization as external lending is cut back more than domestic lending. However, we do not observe the same effect of nationalization on *British* banks. That is, not all governments seem to act the same upon bank nationalization.

On the liabilities side we find similar results. When a foreign bank is nationalized, it increases the fraction of its foreign liabilities by around 14%, almost exactly the same as the increase in foreign assets. Not only do nationalized foreign banks tilt their lending practices away from the UK; they also tilt their borrowing away, and to a similar degree.

These results are not mechanically implied by those on the asset side. While, in an accounting sense, total assets need to equal total liabilities plus shareholders' equity, there can be stark differences in the composition because assets in one country can be financed with liabilities from another. In the presence of time effects, our results on the liabilities side can be interpreted as reflecting a bank's demand for UK versus foreign deposits. In times of uncertainty, nationalized banks, essentially by definition, provide the safest home for deposits. A rise in foreign nationalized bank preference for foreign, as opposed to British, deposits is therefore consistent with the idea that government interventions may have an adverse impact on banking globalization. We also find a smaller (but statistically significant) effect of foreign capital injections on foreign funding.

The Breadth Effect: Overseas Assets

Banks' foreign assets are often spread across many countries. It is natural to ask if banks' portfolios become more alike upon nationalization, reflecting the policy preferences of the government. We ask whether nationalized banks' cross-country portfolio mixes converge in the wake of nationalization. We interpret convergence as evidence of government intervention that limits the *breadth* of banking globalization.

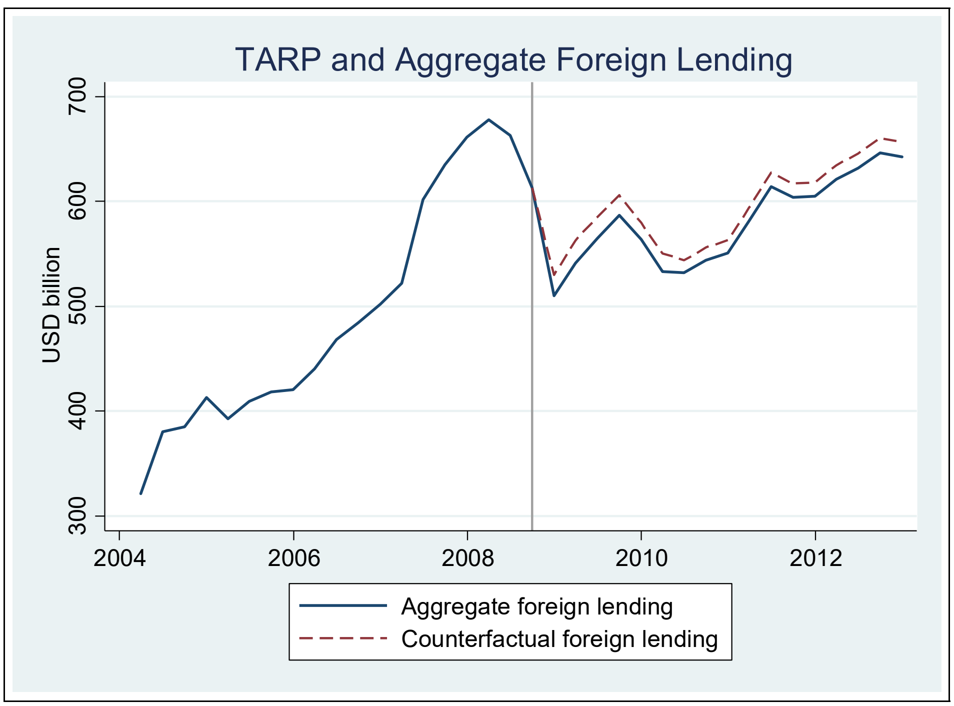
Using a measure of similarity of banks' assets we document that if two banks from different countries are nationalized, the similarity of their cross-country portfolio mixes falls by a large and statistically significant amount. In particular, we find that the similarity of assets is approximately halved when both banks are nationalized. More strikingly, we find that the similarity of a pair of banks' cross-country portfolio mixes *rises* significantly when the nationalized banks are from the same country.

These results are consistent with the idea that the external lending preferences of banks from the same country converge after both are nationalized because authorities impose their lending preferences on nationalized institutions. Overall, the reduction in the breadth of financial globalization is likely to be associated with an increase in systemic risk since banks have less diversified portfolios, a troubling consequence of bank nationalization.[4]

How Persistent is Financial Protectionism: the TARP

To assess the durability of these effects, we compare the growth of cross-border lending upon TARP entry and exit. The United States TARP program is a natural setting to examine persistence, since unlike recent bank nationalizations, many banks have exited TARP. We find some evidence that banks seemed to discriminate against foreign lending after entry into TARP, but there is also evidence (albeit weaker) that this was reversed upon TARP exit. That is, the effects of large public interventions seem to dissipate after the intervention has ended. These effects are small, although not trivial. A counterfactual exercise suggests that aggregate US foreign lending would have been 3.3% higher in the absence of TARP (see Figure 1). This suggests that once public interventions are unwound globally, growth rates in cross-border bank lending may return to those observed before the crisis.

Figure 1: Aggregate foreign lending around TARP (USD, billion)



Conclusion

Government ownership is not the only possible friction or reason why cross-border bank lending has remained stagnant since the 2007-2009 crisis (Forbes, 2014). In this column, we discuss and show that government ownership could be an important friction inhibiting cross-border bank activity in both the UK and the US. We also provide some evidence that these effects might wear off after the interventions are unwound. If the same mechanism applies to other countries around the world, and if government intervention is indeed an important friction, then global banking intermediation may rebound once again, once banks are privatized..

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Endnotes

[1] See the 2014 annual report of the BIS, http://www.bis.org/publ/arpdf/ar2014e.htm.

[2] The April 2015 *Global Financial Stability Report* provides evidence of financial fragmentation and links it to tighter cross-border regulation, especially due to European bank retrenchment; see chapter 2 of the *GFSR*.

[3] For example, French banks in receipt of government support pledged to increase lending domestically by three to four percent, and the Dutch bank ING announced that it would lend EUR25 billion to Dutch businesses and households as part of receiving government assistance (World Bank, 2009). Similarly, the US TARP program specifically stated that one of its objectives was to increase domestic lending.

[4] We thank Takeo Hoshi for pointing this out to us.