Supervision and the location choices of multinational banks *Jean-Édouard Colliard, Giacomo Calzolari and Gyöngyi Lóránth*

The Bracken column is named after Brendan Bracken, the founding editor of The Banker in 1926 and chairman of the modern-day Financial Times from 1945 to 1958. This column reflects his enormous contribution to the open discussion and understanding of international finance and banking. It focuses on providing views and perspectives on how to improve the global financial system.

Today's large multinational banks (MNBs) are extremely mobile across borders. The preparations for Brexit are the best illustration of this fact: Andrea Enria, chair of the European Central Bank (ECB) Supervisory Board, recently revealed that 24 banks based in the UK had moved €1.3bn of assets to the eurozone, an amount comparable to the total assets of Barclays Bank. Seven of these banks will directly be supervised by the ECB, which has since 2014 been responsible for the largest banks in the eurozone.

Of course, MNBs closely follow changing markets, profitability and risks. But they also promptly adapt to regulatory reforms; for example, those enacted in Europe and worldwide after the financial crisis. In a recent academic paper, we provided a framework to analyse the impact of such reforms on MNBs' decisions, and ultimately on financial stability.

CONTRASTING OUTCOMES

MNBs have many options for addressing the different regulatory oversights of different countries. The Icelandic crisis offers a good example of the difference between the two most common legal structures, branches and subsidiaries. Iceland's Landsbanki operated a branch in the UK, branded Icesave. The Icelandic authorities remained its primary supervisor, and its deposits were covered by the Icelandic deposit guarantee scheme. When Landsbanki failed, this scheme did not have sufficient funding to reimburse foreign depositors. In contrast, fellow Icelandic bank Kaupthing operated a subsidiary, named Kaupthing UK, which was supervised by the UK authorities. When it failed, depositors were promptly reimbursed by the UK deposit guarantee scheme.

Importantly, MNBs can strategically change the legal structure of a given unit. For example, during the sovereign debt crisis in the eurozone, several banks converted their subsidiaries operating in Portugal into branches (*Bonfim and Santos, 2017*). As a result, these banks came under the supervision of the authorities of the parent banks' countries of incorporation, and were covered by their deposit insurance funds. More generally, a 'branchification' process seems to be at play in Europe, at odds with the growing use of subsidiaries at the global level (*BBVA Research, 2016*).

When an MNB operates foreign subsidiaries, it faces multiple national supervisors with potentially diverging objectives. This conflict can either be beneficial or detrimental to the MNB, and foreign subsidiaries can face either too much or too little supervision as a consequence. In both cases, the outcome is undesirable for the supervisor in the MNB's home country. A natural response to this problem is to attribute the supervision of both the home unit and the foreign units of the MNB to the same supranational authority. This is what has been implemented in the eurozone: the most significant banking groups are directly supervised by the ECB, which as a European institution is not supposed to display any national bias.

ROOM FOR ADJUSTMENT

Supranational supervision can improve the supervision of an MNB with a given structure, but one must also account for the ability of MNBs to adjust their legal structure to a supervision framework. For example, when a central supervisor such as the ECB is perceived as tougher than the local supervisor of a subsidiary, this removes an incentive for the MNB to operate a subsidiary rather than a branch. The MNB can react by converting its subsidiaries into branches, thus partly undoing the impact of the regulatory change.

A more dramatic possibility is that MNBs might reconsider operating foreign units at all. In that case, there is a balance to strike between strengthening banking supervision and fostering entry and international competition.

A significant example of a change in legal structure following the centralisation of supervision in the eurozone is that of Nordea. In 2017, Nordea converted its subsidiaries in Denmark, Finland and Norway into branches, and then moved its headquarters from Sweden to Finland. This move ultimately transferred supervisory responsibility for all the bank's units to the ECB.

As our analysis makes clear, a key factor for conflicts of objectives between supervisors and for MNBs' strategic response is the inadequate pricing of deposit guarantees. When a bank operates with a branch, it commits to using its equity in the home country to repay depositors in the host country, which is not the case with a subsidiary. We advocate making deposit insurance premia sensitive to an MNB's legal structure, and rewarding structures that are less demanding of public funds. Using such a price instrument may be more efficient and less disruptive for banks' decisions than additional layers of regulations and constraints on MNBs. TB

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