Regulatory Arbitrage and International Bank Flows

Joel F. Houston
University of Florida

and

Chen Lin
The Chinese University of Hong Kong
Hong Kong Institute for Monetary Research

and

Yue Ma
Lingnan University
Hong Kong Institute for Monetary Research

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Summary

We study whether cross-country differences in regulations have affected international bank flows. We find strong evidence that banks have transferred funds to markets with fewer regulations. This form of regulatory arbitrage suggests there may be a destructive “race to the bottom” in global regulations which restricts domestic regulators’ ability to limit bank risk-taking. However, we also find that the links between regulation differences and bank flows are significantly stronger if the recipient country is a developed country with strong property rights and creditor rights. This suggests that while differences in regulations have important influences, that without a strong institutional environment, lax regulations are not enough to encourage massive capital flows.