Implications of Liquidity Management of Global Banks for Host Countries — Evidence from Foreign Bank Branches in Hong Kong

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Summary

Global banks played a key role in transmitting financial shocks internationally thereby contributing to the 2007-08 global financial crisis (GFC). With a strong presence of global banks in Hong Kong, the local banking sector is not immune to inward spillovers of shocks from global banks' home countries. In view of this, this paper quantifies how funding shocks to global banks' parents during the GFC affected the loan supply of their branches in Hong Kong through an internal capital market channel.

Using a regulatory dataset of foreign bank branches in Hong Kong and public data for their parents, the empirical results confirm the findings of recent studies that internal capital markets of global banks respond to a parent-bank funding shock. Specifically, global banks react to a parent-bank funding shock by repatriating net internal funding from their Hong Kong branches, leading to a significant reduction in loan supply, particularly for those branches that have a high loan-to-asset ratio. A higher level of liquid assets held by parent banks and central bank liquidity are found to reduce the extent of shock transmission significantly.

These findings have two implications. First, as central bank liquidity is a significant factor affecting global banks' cross-border internal funding flows and their foreign branches' loan supply, normalisation of liquidity by central banks in advanced economies could reduce loan supply by global bank branches in Hong Kong, although macroprudential measures such as the stable funding requirement introduced by the HKMA may help to dampen loan cyclicality. Second, our findings indicate that liquid assets held by parents and internal funding from Hong Kong branches are regarded as close substitutes by global banks. Therefore, the liquidity requirements of Basel III may reduce global banks' reliance on cross-border internal funding support in times of stress, thus helping to reduce the extent of cross-border transmission of financial shocks through the channel of global banks' internal capital markets.