

# **Economic Motives for Foreign Banking : The Danish Case**

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## **I. Introduction**

Around the middle of the 1970s Danish banks started “going international” by establishing partly or fully owned subsidiaries, branches and offices outside Denmark<sup>1</sup>. The economic reasons for this development are the subject of the following discussion, which should also be valid for banking in other small countries. Accordingly, the comments are also applicable to an important part of the activities of the smaller Euro-banks. They are somewhat more extensive than necessary for explaining the existence of the bigger Eurobanks (i.e. national regulations, see e.g. *Aliber* [1980]).

As a background for the discussion I shall first deal with the activities of banks in general, and then with the kind of international banking which is most important for the foreign subsidiaries of Danish banks<sup>2</sup>.

## **II. The Activities of Banks in General**

Banks are financial intermediaries specializing in receiving deposits from and lending to their customers. However, such an allocation of

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<sup>1</sup> At the same time a few foreign banks began to establish branches and offices in Denmark. By the end of 1979 there were 4 branches of foreign banks in Denmark. At the same time there were 5 subsidiary banks in Luxembourg fully owned by Danish banks, 1 branch of a Danish bank in New York and 7 Danish banks each with a branch at Cayman Islands. There is no official figure for the number of subsidiaries partly owned by Danish banks, but the activities of these subsidiaries are not unimportant for the question discussed. The Danish bank-owners are commercial and savings banks, and the seven big banks all have foreign subsidiaries. There are no official statistics on the activities located at the foreign subsidiaries, but it is commonly regarded as considerable. On the total mediation of foreign loans by Danish banks see below.

<sup>2</sup> See e.g. *Friedman* (1977), who as a result of the paucity of literature on international financial intermediation also takes as a point of departure theories of national banking and then proceeds to discuss the international aspects. See *Baltensperger* (1980) for a general review of theories of the theories of the banking firm.

the same for deposits and loans. However, in many cases the banks will receive deposits on other terms than they themselves place the funds in loans and bonds. Often deposits of the banks will have a shorter term of notice than the effective period in which the banks can disengage themselves from the loans. Correspondingly, the interest of deposits and loans normally is variable without notice, but the same is not true for funds placed by banks in bonds etc.

These kinds of transformation of terms are normally called the creation of liquidity by banks. The first kind of liquidity created by the differences in terms of notice is due to the comparative advantages of the banks with respect to their costs as financial intermediaries. Thus, when the banks are willing to give rather long loans on the basis of short term deposits, the reason is that the market for deposits is functioning quite well. Therefore the banks are reasonably certain that they will be able to substitute deposits withdrawn by new deposits, but perhaps at a higher rate of interest. To the extent that the individual bank is not sure that it can obtain sufficient new deposits at a short notice, it will place a certain fraction of its deposits in cash or easily saleable bonds. By the same token, these funds are not part of the liquidity created by the bank.

The kind of liquidity created by borrowing at variable interest rates and lending by holding, e.g. bonds at fixed interest rates is normally of a secondary importance to the banks. This transaction assumes that the banks have less risk aversion than their customers. Otherwise, the customers would themselves run the implied risk connected with the holding of longer term bonds instead of placing the funds in deposits with a variable rate of interest. Accordingly, this creation of liquidity is performed mostly in the case where deposits are made by smaller customers.

In addition to this financial intermediation and creation of liquidity the banks also carry out national as well as international payments for the clients. This activity is also a consequence of the relatively low costs in this kind of business.

### **III. International Banking**

Most banking is retail-banking carried out by banks owned by individuals from the same country as the country of origin of the customers. However, in the absence of legal constraints there is no reason why

financial resources does not necessarily require the existence of banks. The original lenders themselves could make contact and place their resources directly with the final borrowers.

When the banks do act as intermediaries, the reason must be that as a consequence of their size and specialized activities they are able to perform this financial intermediation in a cheaper, safer and more convenient way compared to others. This will not necessarily be so for all kinds of allocation of financial resources. Therefore an explanation of the activities of banks, which takes as a starting point the advantages for the original lenders and the final borrowers, also includes the possibility of other kinds of financial intermediaries, e.g. mortgage institutions and the possibility of non-institutionalized credits.

To be more explicit, the advantages of intermediation through banks are first that within the framework of public regulations among other things the depositors can easily judge whether the banks can and will meet their obligations. Second, that the banks for their part have a comparative advantage in the credit rating of final borrowers. Especially, the last point is a consequence of a rather large element of fixed cost involved in rating etc. With such fixed costs it is possible to increase the profit of the intermediaries, the net interest payment to the original lenders and/or decrease the cost to the final borrowers, if the borrowing of each client goes through a single or a few banks instead of going through many.

The fact that banks often extend credit on the basis of customers' total economic position is an additional reason why they are uninterested in sharing their customers with other banks. The banks balance these two aspects against their desire of risk minimization and thus of spreading the risk connected with lending to any given client among more institutions.

For smaller customers the fixed cost argument is more important than risk spreading, and consequently individuals and smaller firms will usually have connections with only one bank, while larger customers (relative to the bank) are likely to obtain credit from more than one bank. For this reason the relationship between a bank and its smaller borrowing customers will not be a perfectly competitive one, but will instead give the bank some degree of a monopolistic position.

The financial intermediation discussed above implicitly assumes that the terms with respect to variation in interest rates and maturity are



such banks could not be owned by foreigners. It has been the case for British banks in the former colonies both at the time of their status as such and later during their independence. Such an international activity may normally be attributed to the fact that the bank owners in the mother country have comparative advantages with respect to "management" and other "know how" in administrative affairs. However, there is no reason to assume that these advantages will be very pronounced between fairly equally developed countries as to justify to a larger extent foreign ownership to normal retail banks in the industrialized world<sup>3</sup>.

As one would expect, therefore, this is not the reason why Danish banks have set up a number of foreign subsidiaries and branches in recent years. Nor is the absence of non-interest paying reserves requirements a motive for establishing Eurobanks, as such requirements are of no importance for Danish banks. These foreign subsidiaries owe their existence to the desire by Danish banks to use their knowledge of the credit worthiness of their clients. That this is the case can be seen from the fact, that at the end of 1979 the Danish banks' guarantees for foreign loans of their clients amounted to 22.5 percent of their total lending. In the category of non-financial corporations the guarantees amounted to as much as 52.8 percent of their lending to this group<sup>4</sup>.

When the clients of Danish banks turn to foreign capital markets, their borrowing could in principle take place on the basis of a credit rating accorded directly by foreign institutions. However, in many cases it is cheaper to go via the Danish banks, the reason being the above-mentioned fixed costs in credit rating. Therefore, when Danish banks mediate a foreign loan, it assumes an already existing or an expected normal customer relationship to such borrowers. Consequently, the intermediation of foreign loans by Danish banks is normally an intermediation of loans for Danish borrowers.

As the weight of the fixed cost of credit rating decreases in importance as the total cost of borrowing increases, the further consequence is that the "competitiveness" of Danish compared to foreign banks decreases both with the size and the maturity of the loan. The costs of and demand for a rapid credit rating also increase with the risk of the loan. Therefore the intermediation of foreign loans by Danish banks will

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<sup>3</sup> See *Grubel (1977)*.

<sup>4</sup> See *Statistiske Efterretninger (1980)*.

mostly be in connection with short or medium term borrowing by smaller Danish firms.

In case of a loan with a long maturity or a single credit rating, the *a priori* information of the Danish lender will be of a minor importance or not exist at all. Accordingly, without legal constraints one can assume that competition between e.g. Danish and foreign mortgage institutions will be more keen than between Danish and foreign commercial banks.

Before setting up foreign subsidiaries and branches, Danish banks usually mediated foreign loans by issuing at a commission a guarantee to the foreign bank extending the credits directly to the Danish customers. By establishing foreign subsidiaries and branches the Danish banks are changing this pattern. A prerequisite for this change of course is that the foreign banks ask a higher commission and/or rate of interest in the former way of mediating the loans than in the case where Danish banks themselves get the necessary funds on the international money or capital markets. When under similar risk assessments the foreign banks demand different payments from different customers, such price discrimination must be derived from a certain monopolistic position. Further, it is this difference in interest and commission that Danish banks try to capture through their new activities. With the greater amount of Danish borrowing in the last couple of years the total of these differences has grown enough to cover some extra costs and some additional profits for the Danish banks.

However, this does not explain why Danish banks do not just receive deposits from foreign banks, place them on their domestic balances and then relend these funds to their customers. Of course, it could be that cost or tax considerations play a role in their choice between foreign and domestic book-keeping. Such considerations are not important in explaining why Danish banks go international, but may of course play a role for the choice between different locations for a given foreign activity<sup>5</sup>. The principle reason for the foreign intermediation of foreign loans by Danish banks in their foreign subsidiaries is the Danish official foreign exchange regulation. This regulation prevents the Danish banks, through their domestic offices, from providing more than a small amount of foreign funds to Danish customers. That such a regulation has led to the establishment of foreign subsidiaries of Danish banks is only a

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<sup>5</sup> The same is true with respect to differences in banking and company regulations, e.g. the banks set up subsidiaries in Luxembourg, while they very often set up branches in the US.

confirmation of the often mentioned fact that the existence of Euro-banks is conditioned by some kind of official regulation that prevents or makes certain kinds of national banking more expensive than necessary.

As mentioned, the borrowing customers of the foreign subsidiaries of Danish banks are normally smaller customers of the main banks, who wish to borrow foreign funds. Therefore it is also a condition for the existence of these subsidiaries that Danish monetary policy either by high rates of interest or quantitative ceilings on the internal activities of Danish banks provides an incentive for smaller corporations to borrow in foreign capital markets. As the rather tight monetary policy in Denmark reflects the authorities' intentions of financing and/or reducing the deficit on the current of account of the balance of payments, this deficit is a contributory cause to the existence of the foreign subsidiaries. To cover the fixed costs of establishing the subsidiaries it is also necessary that the Danish banks assume this state of affair to continue for a while. That is probably not a restrictive assumption, as for many years Denmark has had a considerable and growing current account deficit.

The size of the foreign deposits, which forms the basis for the new structure, is normally considerable. At the same time the Danish customers are certainly smaller corporations, but not individuals. Therefore the individual loans of the subsidiaries are not small compared to the mediating bank. The creation of liquidity through changes in the interest terms is therefore insignificant, and the funds received by the Danish banks are normally lent on the same terms of interest (and in the same currency, but of course with a margin), as those which apply to the deposits. The Danish banks are here in line with the behaviour of the traditional Euro-banks, where this kind of business is also of a minor importance<sup>6</sup>.

The creation of liquidity by transforming the maturity of the foreign deposits is a more important business for the foreign subsidiaries. The deposits are formally and actually on short terms, while the lending has a somewhat longer maturity<sup>7</sup>. However, as the international capital and money markets are very well functioning, the risk in such a transformation is under normal circumstances relatively small.

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<sup>6</sup> See Niehans and Hewson (1976).

<sup>7</sup> The Danish exchange regulations require that an important part of the borrowing ("fi-hanslån") does not have an average maturity shorter than 3 years.



#### IV. The Limitation Placed on Danish Monetary Policy

Finally, it is natural to comment on how the Danish monetary policy will be or already has been affected by this new institutional framework for private borrowing in foreign money and capital markets.

The Danish monetary authorities have often used the monetary policy with the purpose of regulating internal activity and employment. Due to the need for private financial capital inflows, it has, however, sometimes been necessary to change target and arrange the policy according to both the rates of interest on foreign capital markets, and to the private sector's expectations with respect to the value of the Danish krone.

With fixed exchange rates the limits within which the authority can choose between different targets are set by the transaction costs of the international capital flows of the private sector<sup>8</sup>. As the competition between foreign banks and the foreign subsidiaries of Danish banks intensifies, this will reduce the costs of transaction to the private sector. Accordingly, it may be assumed that the foreign subsidiaries of the Danish banks, which integrate the Danish and the international capital markets, will also reduce the freedom of the Danish authorities to pursue an independent monetary policy.

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<sup>8</sup> See e.g. Aliber (1978).

## **Zusammenfassung**

### **Wirtschaftliche Motive für Auslandsbankgeschäfte: Das Beispiel Dänemarks**

Warum dänische Banken Auslandsfilialen und -zweigstellen einrichten und dadurch einen besonderen, aber wichtigen Teil ihrer Aktivitäten ins Ausland verlagern, kann letztlich nicht durch einen, sondern nur durch mehrere Umstände erklärt werden. Aufgrund fester Kosten bei der Kreditvergabe werden die meisten ausländischen Kredite an dänische Kreditnehmer nicht von ausländischen, sondern von dänischen Banken vermittelt. Da ausländische Banken selbst bei gleichem Risiko eine höhere Kommission und/oder einen höheren Zinssatz bei einem direkten Kredit an einen dänischen Kunden fordern als es der Fall wäre, wenn dieser Kredit formell über die Bücher dänischer Banken liefe, können die dänischen Banken die monopolistische Preisgestaltung der ausländischen Banken ausnutzen, indem sie selbst die Gelder entgegennehmen und an ihre Kunden weitergeben. Zusammen mit einer wachsenden Nachfrage nach ausländischem Geld und den offiziellen dänischen Bestimmungen, die es dänischen Banken untersagt, ihren Kunden über ihre Inlandszweigstellen in großem Umfang ausländische Gelder zur Verfügung zu stellen, erklärt dies, warum dänische Banken Auslandsfilialen und -zweigstellen einrichten. Diese neue Struktur der Aktivitäten der Banken wird die Kosten für die Aufnahme von Auslandskrediten senken und damit die Freiheit der dänischen Behörden, eine unabhängige Geldpolitik zu verfolgen, einschränken.

## **Summary**

### **Economic Motives for Foreign Banking: The Danish Case**

In sum not one but many circumstances are necessary to explain why Danish banks set up foreign subsidiaries and branches, and in this way place a special but important part of their activities abroad. Due to fixed costs in credit rating most foreign loans to Danish borrowers are mediated not by foreign but by Danish banks. As foreign banks even with the same risk ask a higher commission and/or rate of interest on a direct loan to a Danish customer than if formally placed through the books of the Danish banks, the latter can exploit the monopolistic pricing by the former by themselves receiving the funds and placing them with their customers. Together with a growing demand for foreign funds and the official Danish regulations which prevent the Danish banks through their domestic offices to provide on a large scale foreign funds to their customers, this explains why Danish banks set up foreign subsidiaries and branches. Such a new structure for the activities of the banks will tend to reduce the cost of foreign borrowing and will thus tend to reduce the freedom of the Danish authorities to pursue an independent monetary policy.



## Résumé

### **La motivation économique des opérations bancaires internationales: L'exemple du Danemark**

Ce n'est point une, mais plusieurs circonstances qui expliquent pourquoi des banques danoises implantent des filiales et des agences à l'étranger et transfèrent par conséquent une fraction particulière, mais significative, de leurs activités hors frontières. Pour raison de coûts fixes de distribution des crédits, la plupart des prêts étrangers à des emprunteurs danois sont octroyés non par des établissements étrangers, mais par des banques danoises. Comme pour un même risque, les banques étrangères réclament une commission plus importante et/ou un taux d'intérêt plus élevé pour des prêts directs à des clients danois que ce ne serait le cas si les crédits transitaient formellement par des banques danoises, celles-ci exploitent la structure monopoliste des prix des banques étrangères pour emprunter elles-mêmes les capitaux à relayer à leurs clients. Le développement de la demande de capitaux extérieurs et l'interdiction faite par les dispositions légales danoises aux banques du pays d'offrir dans leurs établissements domestiques du crédit étranger sur une large échelle expliquent l'implantation par les banques danoises de filiales et d'agences à l'étranger. Cette nouvelle structure des activités bancaires abaissera le coût des emprunts à l'étranger et réduira par la même occasion la liberté des autorités danoises de pratiquer une politique monétaire autonome.