

# Directions of improvement of multinational banks' credit activity regulations in terms of debt-type economy

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## Abstract

**Research background:** Amidst deepening economic internationalization and financial globalization, multinational banks remain the most important financial intermediaries in the international debt capital market. By ensuring the cross-border movement and redistribution of credit resources, multinational banks' credit activities lead to the accumulation of external indebtedness in the host countries.

**Purpose of the article:** The purpose of the article is to substantiate scientific and practical recommendations for improving multinational banks' credit activities regulations in order to minimize their negative impact on the level of external indebtedness and the formation of the debt-type economy in the host countries.

**Methods:** Methods of abstraction, systematization and generalization, as well as system approach have been used in our research.

**Findings & Value added:** A hierarchical system of multinational banks' credit activity regulation, which includes institutional-subjective (the level of multinational banks themselves), macro-regional (the level of the home country and host countries), mega- and meta-regional, and global levels have been proposed. Scientific and practical approaches to regulating multinational banks' credit activities, which are based on the introduction of special regulatory measures by the countries with debt-type economies (transformation of external financing sources, revision of forms of credit cooperation with multinational banks, intensification of inclusion in the processes of securitization of credit relations, introduction of a system of macroprudential regulation instruments, increasing the level of international liquidity), have been developed.

**Keywords:** *debt-type economy; regulation; multinational banks; external indebtedness*

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## **1 Introduction**

The results of our previously published research confirm the existence of a strong relationship between external debt in most developed and developing countries (in particular, those of systemic importance to the world economy) and direct cross-border loans provided by MNBs, and show that MNBs' lending is an important source of debt-type economy formation in the world (Zapotichna, 2020).

The ambiguous impact of MNBs' lending on the economy of the host countries, the potential risks of excessive external debt accumulation indicate the need to develop and implement a number of measures to regulate MNBs' lending at various levels.

The purpose of the following article is to substantiate scientific and practical recommendations for improving the system of MNBs' lending activities regulation in order to minimize their negative impact on the external debt and the formation of the debt-type economy in the host countries.

Three groups of scientific articles construct the theoretical basis of our research. The first group is represented by articles in which theoretical approaches to the study of the emergence of external debt and the formation of the debt-type economy, practical aspects of assessing the level of external debt and its management are overviewed (Muhanji and Ojah, 2011; Kumar, Bhutto, Mangrio and Kalhor, 2019; Dey and Tareque, 2020; Anderu, Omolade and Oguntuase, 2019). Conceptual researches of the features of MNBs' lending activities regulation, presented in the scientific works by (Gibilaro and Mattarocci, 2021; Haufler A. and Wooton I., 2021, Calzolari, Colliard and Lóránth, 2019; Álvarez, García and Gouveia, 2016; Samitas and Polyzos, 2015; Figuet and Lahet, 2014; Calzolari and Lóranth, 2011) construct the second group of the articles. Finally, the third group is represented by scientific articles which analyze, assess and classify the determinants of cross-border bank flows (Barrell and Nahhas, 2020; Müller and Uhde, 2013; Aysun and Hepp, 2016; Horobet, Radulescu, Belascu and Dita, 2021).

## **2 Methods**

Methods of abstraction, systematization and generalization, as well as system approach have been used in our research.

Despite the large number of scientific publications on MNBs' lending and external debt, there is a need to conduct thorough economic researches and formulate recommendations aimed at MNBs' lending regulation in the context of its impact on the debt-type economy formation amidst globalization.

Based on the classification of determinants affecting the MNBs' lending activities, proposed in our earlier study and taking into account the scientific achievements of other scholars on the subject of the study, we think that MNBs' lending regulation in the context of its impact on the debt-type economy should be conducted at the following levels: institutional-subjective (the level of MNBs themselves), macro-regional (the level of home and host countries), mega- and meta-regional, and global levels. In other words, the nature of MNBs' activities indicates the necessity to combine «subjective» or «local» (when banks' lending is regulated by host and home countries, and by banks themselves) and «global» approaches to their regulation (when banks' lending is regulated by banking unions, international financial organizations: BIS, Basel Committee on Banking Supervision among many others).

## **3 Results and Discussion**

### **3.1 Institutional-subjective level of MNBs' credit activity regulation**

Institutional-subjective level, which implies internal regulation of lending activities by MNBs, is the basic level of their regulation. The scale and forms of credit activities, and their potential impact on the formation of debt-type economy is primarily determined by the MNBs' credit strategy. Given the results of our earlier research, we believe that in the face of growing risks associated with global financial markets and the general uncertainty of the global economic environment, the implementation of aggressive credit strategies by MNBs will not only provoke further increase in number of debt-type economies and exacerbate external debt problems of individual borrowers, but may also lead to the development of a systemic debt crisis in the world. In turn, debt crises have a negative impact not only on borrowers, but also on creditors, in particular, the MNBs.

Taking into consideration the above-mentioned, the reorientation of MNBs from aggressive lending strategies to conservative and moderate is proposed. On the other hand, given the uncertainty of the global financial and economic environment, it is recommended to increase the flexibility of MNBs' lending strategies, their constant revision, considering a wide range of determinants which impact the choice and formation of their credit strategies.

However, while admitting the necessity of MNB's reorientation to moderate and conservative strategies in terms of their impact on the formation of the debt-type economy, we must state that the possibility of implementing this proposal into practice is questionable, given that it may be contrary to the pragmatic interests of banking institutions, especially given the fierce competition among them in the global debt capital market.

### **3.2 Macro-regional level of MNBs' lending activities regulation (host countries' level)**

Given the actual lack of full-fledged global mechanisms for regulating MNBs' lending and certain obstacles to global coordination, the main measures to mitigate the risks of direct cross-border lending should be implemented, in our opinion, at the macro-regional level.

Based on the analysis of scientific achievements of scientists, we generalized measures aimed at regulating excessive credit growth and systematized them into the following groups: macroeconomic measures (monetary, fiscal and currency); prudential, institutional, administrative and other (advisory and information) measures.

Restrictive fiscal measures are aimed at reducing structural distortions that shift economic incentives. Still the implementation of fiscal measures has some limitations. In particular, limiting government spendings or broadening of the tax base may be complicated in the short-run and may not be available as a quick fix to address pressing issues. In addition, the room for maneuver is limited if the financial situation is already complicated. Political resistance is also possible, given the significant costs of the restrictive policies. Fiscal measures should be applied when rapid credit expansion creates overheating pressures that can undermine macroeconomic stability, especially when the use of monetary policy instruments is limited or absent.

The purpose of monetary measures is to reduce liquidity in the banking system in order to counteract the stimulating effect of credit expansion. In particular, a restrictive monetary policy helps to slow down the demand for credit and can help lower the impact of credit expansion on inflation and the current account balance. Monetary policy measures can reduce the pressure of overheating, which can undermine external macroeconomic stability, as well as when the main monetary regime does not restrict the use of financial instruments. Monetary measures can be effectively provided in countries with relatively closed capital accounts and when the monetary transmission mechanism is working properly, as well as in

a favorable financial situation. However, these measures have certain limitations: depending on the type of exchange rate regime (for example, the currency board), incentives to create an open position in foreign currency that promote credit growth may appear.

Theoretically, moving to greater exchange rate flexibility can help limit direct credit inflows, which have been encouraged by the relative predictability of the exchange rate. More flexible exchange rate currency regime leads to less direct loans received by the country from MNBs. It is important to emphasize on the necessity of a coherent monetary and monetary policy. Thus, if the exchange rate is fixed, interest rates should be set based on the interest rates of the country to whose currency the exchange rate is pegged to. Such a policy limits the incentives for over-borrowing in foreign currency, which is stimulated by the high difference between domestic interest rates and a stable exchange rate. This type of policy should be used when rapid credit growth is stimulated by increased borrowing from abroad, and when banks and their customers create an open currency position due to their belief that currency risk is low.

When there is a significant increase in MNBs' direct loans, increasing the flexibility of the exchange rate regime and maintaining a consistent monetary policy will help limit the direct and indirect impact of foreign currency lending on the economy by reducing the perception of low exchange rate risk.

Taking into account the context of our study, the development and implementation of measures aimed at regulating the MNBs' credit activities at the host country level should be carried out through assessing the nature of the national economy (debt-type or non-debt-type). If the host country's economy is not classified as debt-type, the regulation of credit interaction of national economic entities with MNBs may be based on traditional measures presented above. Debt-type economies in addition to traditional measures are recommended to implement measures aimed at reducing the dependence on external borrowing from the MNBs and improving their external solvency. These measures may include:

1. Transformation of external financing sources with a gradual reorientation from borrowed capital to foreign direct investment, which does not cause the accumulation of external debt.

2. Revision of forms of credit cooperation with MNBs, in particular, reorientation to indirect loans, which are provided in national currency and, as a consequence, allow to eliminate currency risks.

3. Intensifying the country's involvement in the securitization of international credit relations (securities are more liquid debt instruments than traditional bank loans) and the partial transition to financing through the stock market mechanism.

4. Introduction of a system of macroprudential regulation tools. Empirical experience shows that macroprudential measures are effective in managing a number of risks, directly or indirectly related to lending to national economies by MNBs, which are as follows: risks that are exacerbated due to rapid growth of bank loans and rising asset values during credit boom; risks related to high levels of bank leverage; liquidity risks; risks arising from significant and volatile foreign capital flows, including foreign currency lending risks. Such measures, as a rule, have either a general (aimed at settling external borrowings in general) or a special orientation (aimed at regulating the structure or specific types of external borrowing).

Thus, the first type of measures may involve the introduction of a limit on foreign banks' debt obligations in relation to the total amount of their liabilities in order to reduce the possibility of attracting excessive loans from MNBs.

The second type of measures is aimed at limiting short-term foreign loans attracted by the subjects of national economies (a system of non-reimbursable reserve requirements for short-term external borrowings of residents can be used as a tool for their implementation).

5. Increasing the level of international liquidity at the expense of the accumulation of international reserves.

### **3.3 Macro-regional level of MNBs' lending activities regulation (home countries' level)**

It should be mentioned that the regulation of MNBs' lending activities at the macro-regional level through the implementation of appropriate measures by the host country may be insufficient to address the global risks of MNBs' activities. In fact, national policies that reduce domestic risks in a host country indirectly increase risks in other countries and banking systems.

The macro-regional level also includes the regulation of MNBs' lending activities by home countries. Host and home countries should cooperate to resolve the external indebtedness problem. Such cooperation is quite real given the fact that the governments of MNBs' home countries are interested in maintaining the stable financial condition of their banks. A significant part of the resources of parent banks to their subsidiaries in the total amount of foreign lending facilitates the task of settling the foreign debt obligations of domestic borrowers.

A study by Ongena, Popov, and Udell on the impact of MNBs' home countries' regulation on the volume of loans received by host countries shows that, firstly, regulation by home country that does not harm competition, as well as regulation in the home country associated with higher restrictions on banking activities, helps to reduce MNBs' lending in foreign markets. Secondly, regulation by home countries, which restricts certain activities of MNBs or reduces their statutory value, helps to lower the standards of their lending abroad, and banks direct their loans to less transparent borrowers (Ongena, Popov and Udell, 2013). These conclusions are in line with MNBs' «cherry picking» strategy. In general, the results of the study obtained by these authors suggest that regulation of MNBs' lending activities by home countries can have a significant impact on their lending activities in foreign markets.

Given the information above, the main areas of regulating MNBs' lending at the level of home countries should include: approximation of national banking legislature to the requirements of Basel III (to ensure the financial stability of banks and reduce banks' risks) and create stable macroeconomic conditions for banks' lending (empirical experience shows that, as a rule, improving macroeconomic conditions in MNBs' home country increase domestic lending and reduce the volume of loans to recipients abroad, which reduces the risks of exacerbation of the foreign debt problem in the world).

### **3.4 Mega- and metaregional levels of MNBs' credit activities regulation**

Given the tendency to lending within the geographic region (Murshudli, Zapotichna, and Dilbazi, 2020), intensification of MNBs' credit activities regulation at the megaregional (supranational) and metaregional levels can be expected in the nearest future. The global financial crisis of 2008-2009 showed that efforts of individual countries are insufficient in regulating the activities of large and systemically important MNBs. Nowadays, closer cooperation among national banking supervisors is appropriate, in particular at the mega-regional and meta-regional levels. An example of such cooperation at supranational level is the European Banking Union, which has been operating within the European Union since 2012. The need to create the European Banking Union was related to the need to form a single mechanism for the application of banking law in the EU countries, unification of prudential regulation practices by national banking supervisors in order to prevent the growth of sovereign debt of the EU member states. Regulation at the the banking union level, in particular, in terms of capital adequacy ratios, limitation of banking risks, etc., also applies to MNBs, headquartered in the EU.

Cooperation on the regulation of MNBs' lending activities at the metaregional level remains relatively underdeveloped today. Given the intensification of integration processes at the level of metaregions, the growth of their role in the world economy and, in particular, in the global financial system, as well as lack of national and international mechanisms in addressing specific problems of regional financial markets, including banking markets, there is a strong need to create multilateral mechanisms for regulating banking activities at the level of global regions.

In addition to general issues on regulating the regional market of banking services, the activities of such multilateral mechanisms can be aimed at:

- 1) development of joint recommendations on supervision and control of MNBs based in one region;
- 2) coordination of the activities of national regulators in the field of credit policy;
- 3) regulation of MNBs' cross-border lending activities of the region in the context of its impact on the external debt of borrowing countries;
- 4) monitoring of direct cross-border loans received by countries of the region from MNBs' from other regions, assessment of their impact on the economy of the host countries in order to prevent excessive debt growth;
- 5) providing advisory assistance to borrowing countries on a variety of issues, including obtaining of loans or debt restructuring (interaction with the London Club of creditors should be provided on this issue).

Prior to the establishment of specialized regional institutions which can address the aforementioned problems, their functions can be partly entrusted to existing regional financial initiatives such as the Latin American Reserve Fund, the Chiang Mai Initiative and other regional mechanisms.

Näther and Vollmer in their study analyze the incentives of a single country to join a banking union and research how the structure of international banking influences the decision of a national regulator to transfer supervisory powers to a supranational agency. They predominately concentrate on bank supervision and regulation. According to the results of their study, differences between national and supranational regulation occur because of a number of reasons. Firstly, the supranational regulator considers the expected return to all agents from investments abroad, while the national regulator, when regulating a subsidiary, ignores the profit share that is transferred to the subsidiary's parent bank. Secondly, in contrast to the supranational regulator, when regulating a parent bank, the national regulator ignores the total expected stability costs that are incurred by the host country because of parent bank failure. Consequently, a country hosting many subsidiaries joins a banking union if profit transfers are relatively low and if the country's financial stability depends on the parent banks' performance. The consequences for a country with many banks owning subsidiaries is vice versa. The results provide a possible explanation why some EU member states currently hesitate to join the European Banking Union (Näther and Vollmer, 2019).

### **3.5 Global level of MNBs' credit activities regulation**

Given the scale and possible consequences of direct lending by MNBs, it is important to coordinate its regulation at the global level, as inadequate regulation in one country can have negative implications for others.

Modern system of MNBs' credit activity regulation at global level in the context of its impact on the debt-type economy is represented by intergovernmental institutions of three types:

- 1) institutions which deal with MNBs' lending activities and transparency of banking operations (Bank for International Settlements (BIS), the Basel Committee on Banking Supervision, Financial Action Task Force on Money Laundering, among others);

2) institutions involved in settling the external debt of the borrowing countries (IMF, World Bank, Paris and London creditors' clubs);

3) institutions, whose activities are aimed at developing measures to reform the global financial system in order to achieve global financial stability and, accordingly, create a common environment for the MNBs' activities (G20, the Financial Stability Board).

Today, the BIS performs the main functions of monitoring and evaluation of MNBs' credit activity. It is impossible to conduct thorough economic researches and formulate recommendations on the basis of MNBs' lending activities without prior analysis of the data on the volume of loans provided by MNBs, their form, maturity and recipients. A significant problem that arises in the study on MNBs' lending activity is the establishment and modernization of statistical data collecting and recording process. Improving the statistical database is of paramount importance for developing an adequate policy aimed at regulating MNBs' activities. Despite the fact that BIS statistics are the most comprehensive database available for monitoring MNBs' activities in foreign markets, it is not without imperfections.

In order to further improve the BIS database, in our opinion, some changes and clarifications should be made to the relevant methodology, in particular:

1) provide additional information on the currency structure and loan maturities (such information is available only for a small number of countries; some of this data is available in the Consolidated banking statistics on the immediate borrower basis, but not classified by currency);

2) provide separate data on loans provided by MNBs directly from parent banks (direct cross-border loans) in home country currency and loans provided by local MNBs' units in the host country in home country's currency (indirect loans). Thus, in the studies based on the BIS statistics, the data on direct cross-border loans are somewhat inflated, which leads to distortion of the research results.

While recognizing the need to create global mechanisms for regulating MNBs' activities, we think that the global financial system is not yet ready for the reform of this level.

In particular, the introduction of a qualitatively new global institution in the field of MNBs' regulation may face serious obstacles. The consent of all countries (or at least the vast majority) to transfer a part of the powers of national regulators is required to create such an institution. Moreover, the need to implement the standards adopted by such a global institution will require the international unification of financial, banking, tax and other components of national legislation. If the global institution's regulations are not implemented in all countries, global disparities in the development of international banking business may arise due to the reorientation of MNBs to those national jurisdictions that have not implemented international banking standards and where regulations on cross-border banking are less stringent. In addition, the global institution is likely to pursue a common policy and implement unified standards for regulating MNBs' lending activities, which may be impractical when taking into account the regional and local specifics of international banking business.

Considering the abovementioned, the more feasible areas for improving the system of MNBs' activities regulation in terms of debt-type economy are as follows:

1) revision of credit strategies at the institutional-subjective level (at the level of MNBs themselves) in order to reduce the degree of their aggressiveness and compliance with the requirements of Basel III to limit bank risks, strengthen banks' control over the use of loans by borrowers;

2) modernization of national systems of regulating credit relations with MNBs at the host countries level, taking into account the type of the economy (debt or non-debt-type);

3) deepening bilateral and multilateral regional cooperation at the level of MNBs' home and host countries;

4) strengthening the interaction and coordinational functions of international

organizations responsible for regulating international banking and finding solutions to the debt problem of the host countries.

The complexity of creating a full-fledged multi-level system of MNBs' lending activities regulation is due to the special status of MNBs in global financial markets; the scale of the global impact of their operations; conflict of interest between MNBs and host countries, etc. Therefore, an important condition for the effective operation of the entire MNBs regulatory system is the recognition by MNBs of the possible consequences of the impact of their lending operations on the world economy (in particular, potential risks of external debt exacerbation) and the introduction of a model of responsible behavior in their lending. This model of behavior should be based on the understanding that further aggravation of the foreign debt situation in the world due to the implementation of aggressive, risk-free credit strategies may have global consequences, up to the global debt crisis, which will jeopardize the financial condition or even the existence of MNBs. In this context, a system of partnership between the MNBs and the host countries should be formed on the basis of the optimal forms and conditions of lending, while taking into account the interests of both creditors and borrowers in order to prevent the development of the debt crisis.

## 4 Conclusions

Given the growing risks of the debt crisis for debt-type economies, in addition to traditional measures (macroeconomic policy measures (monetary, fiscal and currency); prudential, institutional, administrative), the application of a system of measures aimed at reducing dependence on external borrowing from the MNBs and improving external solvency by the host country have been justified, namely:

1) transformation of sources of external financing due to the gradual reorientation from attracting borrowed capital to foreign direct investment; 2) revision of forms of credit cooperation with MNBs, in particular, reorientation to indirect loans; 3) intensification of the country's involvement in the processes of securitization of international credit relations and partial transition to financing through the stock market mechanism; 4) introduction of a system of macroprudential regulation tools; 5) increasing the level of international liquidity through the accumulation of international reserves.

Considering that some of the proposed measures are difficult to implement in practice, we emphasize the need for further researches to improve the system of MNBs' credit activities regulation. For example, given the fact that financial markets of many developing countries are still insufficiently integrated into the global debt securities market, we believe that the practical implementation of such a measure as intensifying the country's involvement in the securitization of international credit relations and partial transition for financing through the stock market mechanism, has certain limitations on the ability of this group of countries to join the processes of securitization of credit relations.

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