In search of greater regulatory freedom, some banks resort to cross-border acquisitions

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The recent global financial crisis, caused in part by systemic failures in bank regulation, has sparked, among other things, a strong push for both stricter capital requirements and greater international coordination in regulation. For example, seven of the 10 recommendations of the 2011 Report of the Cross-Border Bank Resolution Group of the Basel Committee for Banking Supervision (BCBS) propose greater coordination of national measures to deal with the increasingly important cross-border activities of banks. Some argue this push for tougher regulations and increased restrictions on bank activities may create incentives for "regulatory arbitrage," whereby banks from countries with strict regulations engage in cross-border activities in countries with weaker regulations. The purpose of the study is to shed light on the motives behind regulatory arbitrage by examining one of the most important types of investment decisions that banks can make – namely, cross-border acquisitions.

We focus on whether regulatory arbitrage is a driving force behind the increased cross-border bank acquisition activity observed over the last decade or so and test two competing hypotheses on regulatory arbitrage. On the one hand, regulatory arbitrage could be driven by the search for profitable opportunities if banks from overly restrictive regimes are not allowed to engage in certain risky but value-generating activities. Through bank acquisitions of targets in countries with fewer regulatory restrictions, such banks may escape from costly regulations and transfer sound supervision from the home country. This may yield benefits that accrue not just to the acquirer, but also to the target, which may benefit from "bonding" to a more robust regulatory regime after being acquired by banks from countries with stronger supervision.

On the other hand, a more harmful view of regulatory arbitrage holds that it could lead to a race to the bottom if banks target countries with weak regulations in order to pursue excessively risky, value-destroying activities. This form of regulatory arbitrage could have adverse consequences for bank performance and shareholder value, not only for the parties to the deal but also for the banking system as a whole. We find evidence more in favor of the former than the latter hypothesis.

Cross-border deals are a particularly useful setting to evaluate the effects of regulatory restrictions *not only* because the acquiring banks can escape some of the regulations in their home country by acquiring institutions in weaker regimes *but also* because of the enormous growth in bank consolidation facilitated by major regulatory changes around the world. To the best of our knowledge, ours is the first study to examine regulatory arbitrage in cross-border bank acquisitions on a global basis.

We use a sample of 7,297 domestic and 916 majority cross-border deals cumulatively valued in excess of $2.8 trillion involving acquirers and targets from 78 countries over the period 1995 through 2012. We find that cross-border bank acquisitions are more likely to involve acquirers from countries with stronger supervision, more restrictions on bank activities, and more stringent capital requirements, which suggests that regulatory arbitrage is a motive for cross-border bank acquisitions. These factors are important even after controlling for broader measures of corporate governance, merger control policies, and a host of other factors previously shown to influence cross-border acquisition flows.

We next examine the impact of differences in bank regulation on shareholder wealth as measured by the short-run stock price reactions of the acquirer and target banks to deal announcements. We document that target banks' (and aggregate) abnormal returns are positive *and* significantly larger when acquirers are from countries with more restrictions on bank activities, stricter capital requirements, stronger private monitoring, and better overall regulatory quality. This finding adds support to the more benign escape-from-costly-regulations or bonding views of regulatory

arbitrage. Finally, we document that our results on cross-border bank acquisition flows are driven primarily by push factors. Acquirers from tough regimes do not necessarily target countries with the weakest regulatory quality, a finding which provides additional support to the benign view of regulatory arbitrage.

Our research is important given the renewed focus on coordinated regulation in the global banking sector in the aftermath of the recent global financial crisis. Indeed, the increased importance of regulations and governance mechanisms in the banking industry is highlighted in the Basel Committee's December 2009 Report on Strengthening the Resilience of the Banking Sector, which stresses the vital role governance mechanisms, transparency, and disclosure can play in promoting stability in the banking sector. The impact of these rules and other proposed regulatory changes that would lead to more stringent government oversight of financial institutions throughout the world will certainly have an impact on banks and, in turn, on the financial sector as a whole. A major driver behind this push for tougher regulations is concerns about regulatory arbitrage. Our findings show that not all forms of regulatory arbitrage may be a cause for concern.

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Notes:

- *This article is based on the authors' paper Regulatory Arbitrage and Cross-Border Bank Acquisitions , The Journal of Finance, Volume 70, Issue 6, 2015.*
- *This post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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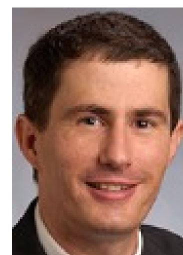

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