Capital Management and Leverage of Foreign Bank Subsidiaries in a Host Country: A Case in Hong Kong

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Summary

The large presence of global banks in Hong Kong offers a well suited empirical setting to study the capital management of foreign bank subsidiaries from a host country perspective. Specifically, this paper uses the trade-off theory of leverage to investigate whether the leverage dynamics of foreign bank subsidiaries in the host country would behave differently to domestic banks. Similar to the behavior uncovered empirically of non-financial firms, we find that the standard determinants of leverage are applicable to banks in Hong Kong. In particular, there is a mean-reverting force which acts as a self-correcting mechanism for their leverage, with over-leveraged banks having a tendency to decrease their leverage, and vice versa. However, the self-correcting mechanism of banks' leverage may in times be unduly disturbed by abundant global liquidity, with the effect on foreign bank subsidiaries tangibly higher than that on domestic banks. The externality generated by current abundant global liquidity affecting foreign bank subsidiaries may require the implementation of macro-prudential policies in the host country to contain the risks stemming from the high leverage of banks and external liquidity shocks.