Committee on the Global Financial System

Foreign direct investment in the financial sector of emerging market economies

Report submitted by a Working Group established by the Committee on the Global Financial System

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Executive summary

Foreign participation in the financial sectors of emerging market economies (EMEs) increased rapidly during the 1990s. It has continued to expand so far in this decade, on balance – although its pace fell somewhat following problems in Argentina in 2002 and the global slowdown in mergers and acquisitions. While banks accounted for the majority of financial sector foreign direct investment (FSFDI), they were joined during this period by securities and investment firms. In a number of countries in Latin America and central and eastern Europe (CEE), foreign banks now account for a major share of total banking assets. In Asia, the share of foreign banks is, overall, much lower, but still substantial.

FSFDI was fostered by financial liberalisation and market-based reforms in many EMEs. The liberalisation of the capital account and financial deregulation paved the way for foreign acquisitions and the integration of EME financial firms into an expanding global market for corporate control. This underlines the character of FSFDI as part of a broader trend towards consolidation and globalisation in the financial industry. In some cases, heightened competition in traditional markets increased pressure on major international banks to find new areas for growth. With financial institutions in advanced economies increasingly searching for profit opportunities at the customer and product level, FSFDI offered a means of access to EME markets with attractive strategic opportunities to expand.

The integration of EME financial firms into the global market has resulted in a wider diversity of financial institutions operating in EMEs and – given their greater emphasis on risk-adjusted profitability – a broad range of business strategies. These include expansion into local retail banking and securities markets, where elements such as client relationships and reputation are important components of the franchise value of operations. Such factors have tended to raise the costs of exiting a country and hence increased the permanence of FSFDI.

Improvements in local financial infrastructure made the risks of conducting business in EMEs easier to manage, but events such as the Russian default in 1998 and Argentine actions in 2002 also made financial institutions more sensitive to the potential consequences of low-probability, but high-cost events involving country risk. Thus, financial institutions in industrial countries now tend to evaluate country risk separately and more rigorously by applying country-focused stress testing and other techniques. Because the objective of preserving the franchise value may have narrowed the room for strategic manoeuvre, risk managers now more actively seek ways to mitigate the impacts of realisations of country risk – for example, by using more local funding and establishing in advance potential sources of funds for stress scenarios. Nonetheless, a projection of long-run profitability remains the prerequisite for staying in the host country.

An important, lasting benefit of FSFDI is its effect on financial sector efficiency that arises from local banks' exposure to global competition. Generally, host countries benefit from the technology transfers and innovations in products and processes commonly associated with foreign bank entry. Foreign banks exert competitive pressures and demonstration effects on local institutions, often inducing them to reassess business practices, including local lending practices. The result can be better risk management, more competitive pricing, and in general a more efficient allocation of credit in the financial sector as a whole.

Foreign banks' presence can also help to achieve greater financial stability in host countries. Host countries may benefit immediately from foreign entry, if the foreign bank recapitalises a struggling local institution and, in the process, also provides needed balance of payments financing. The better capitalisation and wider diversification of foreign banks, along with the access of local operations to parent funding, may reduce the sensitivity of the host country banking system to local business cycles and changing financial market conditions. Their use of risk-based credit evaluation (and spillovers to local banks' practices) tends to reduce concentration in lending and, in times of financial distress, fosters prompter recognition of losses and more timely resolution of problems. In stress situations, foreign-owned institutions can also provide an alternative location for deposits that does not involve capital outflows.

Notwithstanding these benefits, the growing involvement of foreign firms in the financial systems of EMEs has given rise to concerns, especially where a majority of EME banking assets have become foreign-owned. One set of issues arises when integration transforms a domestic institution such that key decision-making and control functions – including strategic planning and risk management – are shifted to the parent. This shift may reduce the information available to host country supervisors and monetary authorities, and it may interfere with the access of authorities to key firm decision-makers.

The reduction in information could become an issue, especially when parent institutions make subsequent strategic changes that significantly affect host country financial markets. If the integrated firms' equities are delisted, the resulting loss of information and market signals may not be fully offset by financial disclosures by the global institution. Another concern is that the financial sector of a globally integrated host country may have greater exposures to shocks that arise from external economic, financial, and strategic developments. The relevance of these issues very much depends on bank and host country-specific factors, such as the business strategy and management approach of individual banks, the legal form of operations or the composition of the host country financial system.

Adjustments in the supervisory framework can help offset the attendant information loss and resulting risks to financial stability. Host country regulators have the capacity to impose information and disclosure requirements on subsidiaries and, in principle, also on branches. In addition to ensuring adequate information from the local operation, supervisors should make fuller use of existing frameworks for cross-border supervisory information sharing. More generally, the mutual benefits of increasing the extent of cooperation among home and host country supervisors are compelling because of the additional complexity introduced by the expansion of banks' operations into EMEs, the intensifying competitive dynamic in global markets, and the potential relevance of EME operations for the risk assessment of the equity holders and creditors of the parent.

Information sharing among authorities responsible for financial stability is especially important in periods of market stress. In such situations, information sharing frameworks often emphasise the flow of information from host to home country. At the same time, however, home country supervisors and financial institutions should recognise the need in the host country for information when the parent bank has problems, especially when the bank's subsidiary is a large presence in an EME's financial markets. Similarly, central banks need to be in close contact when a parent bank's problems appear likely to affect a local EME subsidiary or branch.

Although new strategies by acquired banks may present challenges to supervisors, they can also be a catalyst for developing supervisory skills. Accordingly, developing pertinent technical skills should be an important area of cooperation between authorities in advanced and EME countries. In some markets, foreign-owned banks have been prominent in the rapid expansion of consumer lending and foreign currency lending to both households and businesses. Supervisors need appropriate tools to assess how such credit is managed by banks, and authorities in charge of financial stability may need additional information and techniques to monitor for financial vulnerabilities. Cross-border information sharing, training programmes and other forms of technical assistance may help meet this need.

The EME financial reforms that triggered the 1990s expansion of FSFDI did not come without some costs of adjustment (including having to weather difficult periods) in moving towards a more market-driven system, but they also generated demonstrable and substantial long-term benefits. Accordingly, public policy should be focused on maximising these benefits by continuing to encourage diversity and competition in financial systems – not only between foreign and domestic banks, but also between banks and other financial institutions.

Given the prominence of country risk in investing firms' strategic decision-making, measures aimed at reducing country risk should be especially beneficial. One essential component of host country policy in this direction is a commitment to growth and stability. Another is the protection of property rights and equal treatment of banks, irrespective of ownership. From this viewpoint, a more extensive implementation of the internationally recognised set of financial standards and codes can help to reduce country risk. Another related policy element to reduce country risk is strengthening of legal frameworks. The smooth functioning of the market for corporate control would be assisted by greater international compatibility of accounting standards, takeover rules, and insolvency codes. As highlighted in this report, the availability and quality of local information may be of particular relevance in this context.

Regional integration of EME financial systems, often within a framework for broader economic integration in the region, is another complementary approach to this objective. There is substantial anecdotal evidence of major benefits from regional compacts such as those of the European Union and NAFTA. In the case of very poor countries where some special support for FSFDI may be merited, public sector provided political risk insurance, if properly designed, could be useful.

Purpose and structure of the study

Foreign presence in the financial sector of emerging market economies (EMEs) increased dramatically over the course of the 1990s. In the second half of the decade, financial sector foreign direct investment (FSFDI) inflows were about eight times that of the preceding five years. While banks accounted for the lion's share of FSFDI, they were joined in the expansion in the latter half of the 1990s by securities and insurance firms.

The expansion of FSFDI in the 1990s was seen by policymakers as beneficial to the global financial system. The arguments in principle resemble those in favour of FDI in general:[1] FSFDI contributed to the efficiency of host country financial systems through technology transfer and heightened competition. Entry by foreign, well capitalised institutions with sophisticated risk management was also viewed as beneficial for financial stability. Moreover, FSFDI was valued because it was a source of non-debt external financing for countries emerging from periods of economic and financial disturbances.

The substantial losses of foreign banks in Argentina in 2002 seem to have triggered a reassessment by investors of the risks involved in operations in EMEs. FSFDI in Latin America plummeted subsequent to the Argentine crisis. Investing institutions, also adjusting to the global slowdown in mergers, acquisitions, venture capital finance and IPOs, trimmed risk exposures and operations as part of a larger global restructuring. In a few cases, banks exited countries altogether.

The repositioning of foreign banks brought to the forefront the changing role of FSFDI in EMEs in the strategies of major financial firms. In contrast to the previous decade, developments in the late 1990s showed that FSFDI is no longer ancillary to non-financial FDI as the "follow the client" factor has become much less relevant. Since then, operations in EMEs have been viewed increasingly as part of client- or product-specific strategies and managed like other investments. The adjustment also highlighted how FSFDI transformed host country financial institutions and financial markets in the 1990s. Foreign participation in EME financial systems has become one major channel of integration into the global financial system.

The general question is how to assess the role of FSFDI in the evolving global financial environment. For many countries and financial firms, this amounts to the question of how to manage existing operations. For some other countries that are still less open to foreign participation, especially in Asia, the issue is that of whether, and how, to encourage FSFDI.

In November 2002 the Committee on the Global Financial System (CGFS) established a Working Group to explore the issues that FSFDI in EMEs raises for investing institutions, home and host countries, and the global financial system.[2] The Working Group focused on two sets of issues:

- *The impact of FSFDI*. How should we think about the private and social economic benefits of financial sector FDI? What are the implications for the functioning of host country financial systems? Have recent developments raised questions concerning the strategy of relying on foreign financial firms to strengthen the financial system in EMEs?
- *The management of FSFDI*. What are the risk management issues raised by FSFDI for investing firms and authorities in charge of financial stability? Are the risks fully understood and being managed appropriately? How important is political risk?

The report discusses these issues. The focus is on FSFDI in the banking sector, but the considerations in principle also apply to other financial institutions. It draws on the existing literature on foreign participation in EME financial systems as well as research undertaken in the central banks

[1] FDI flows to EMEs are able to enhance economic growth and financial stability in the host countries. FDI can help to overcome the pervasive investment gaps in EMEs, facilitate economic restructuring and make new technologies and management techniques available. Compared to other forms of financing, FDI exhibits low volatility, making it the least risky form of foreign funding available for EMEs. See Deutsche Bundesbank (2003a).

[2] Annex 1 contains the mandate of the Working Group.

represented in the Working Group.[3] The report also reflects views expressed in interviews conducted with financial institutions running operations in EMEs.[4]

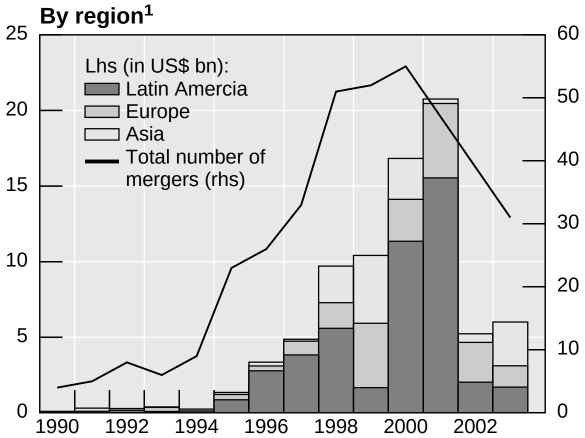
The report is structured as follows. The next part provides an overview of trends in FSFDI since the beginning of the 1990s. The second part discusses the benefits of FSFDI. The third part takes up issues related to the management of the risks involved in the foreign operations of financial firms. The fourth part considers issues for authorities in charge of financial stability and public policy more generally. The final part concludes.

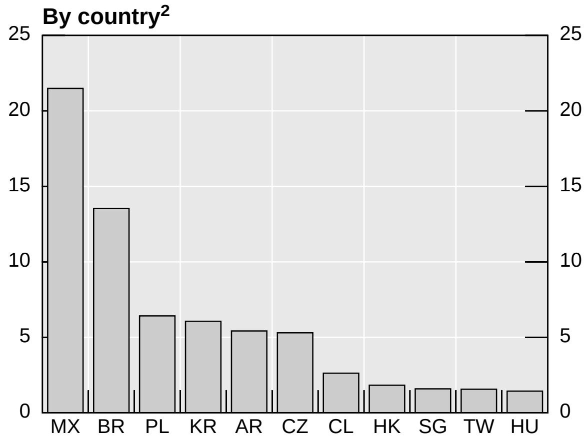
1. The 1990s surge in FSFDI

1.1 Broad trends

FSFDI surged in the latter half of the 1990s.[5] Using cross-border mergers and acquisitions (M&A) targeting banks in EMEs as a proxy,[6] the value of FSFDI rose from about $6 billion from 1990-96 to almost $50 billion in the following four years (Graph 1). Along with total FDI, FSFDI peaked in 2001 with a value of about $20 billion.[7] FSFDI declined sharply in 2002, but stabilised in 2003 well above the levels seen in the first half of the 1990s. FSFDI in EMEs also gained importance relative to cross-border mergers within developed countries. The share of M&A cross-border deals involving financial institutions from EMEs as targets increased from 18% in 1990-96 to 30% in 1997-2000.

Graph 1 **Acquisition of banks in EMEs**





MX = Mexico, BR = Brazil, PL = Poland, KR = South Korea, AR = Argentina, CZ = Czech Republic, CL = Chile, HK = Hong Kong SAR, SG = Singapore, TW = Taiwan (China), HU = Hungary.

[1] By residency of purchased bank. [2] Cumulative from 1990 to 2003, in billions of US dollars.

Sources: Thomson Financial; Bank of England.

[3] The bibliography separately lists the background papers submitted by Working Group members. The papers marked with an asterisk are available on the BIS website.

[4] Annex 2 contains a summary of the interviews.

[5] On the trends in FSFDI in the 1990s, see Focarelli (2003)* and Soussa (2003)*.

[6] On the issues associated with quantifying FSFDI, see Box 1 on page 9.

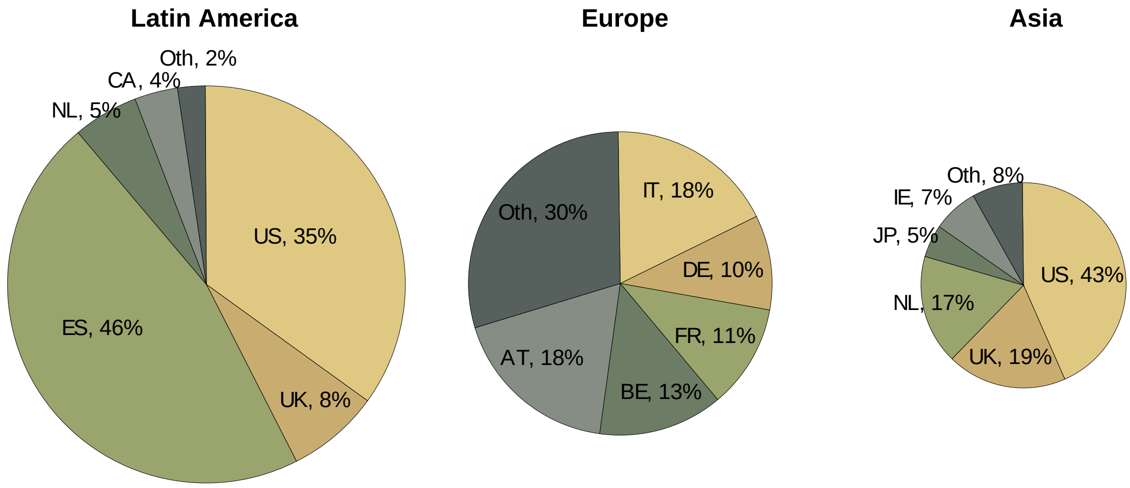
[7] On the trends in FSFDI in the context of overall capital flows, see Deutsche Bundesbank (2003a)*.

FSFDI inflows displayed considerable regional differences (Graph 1). Between 1990 and 2003, the majority of flows entered *Latin America*. Overall, transactions targeting banks in the region accounted for $46 billion or 56% of total cross-border M&A. FSFDI progressed steadily from 1995 onwards (following the Mexican crisis) with the exception of 1999 (Brazilian crisis) and 2002 (Argentine and Brazilian crises). Mexico accounted for about 50% of the cumulative investment in the region from 1990 to 2003.

Countries in *central and eastern Europe* (CEE) became major recipients of FSFDI when the privatisation of their banking system and preparations for EU membership took place in the second half of the 1990s.[8] Cross-border M&A deals involving CEE financial firms were about $20 billion or 24% of all cross-border deals. Poland and the Czech Republic experienced the highest inflows.

The proportion of cross-border M&As in *East Asia's* financial sector has been small compared with other regions. The value of cross-border M&As targeting non-Japan Asian countries was $14 billion or 17% of the total during 1990-2003. Asia, however, has been one of the fastest growing target regions for M&A, with a sizeable jump in cross-border M&A activity occurring in Korea and Thailand. In addition, there has been a large number of small-value cross-border M&A transactions in the finance sector between East Asian economies.[9] In 2003, Asia received the largest share of FSFDI inflows.

Graph 2 **Source of FDI by region [1]**



Note: The size of the individual pie charts reflect the area's share in total acquisition of banks by financial institutions located in developed countries.

AT = Austria, BE = Belgium, CA = Canada, DE = Germany, ES = Spain, FR = France, IE = Ireland, IT = Italy, JP = Japan, NL = Netherlands, UK = United Kingdom, US = United States, Oth = other.

[1] Value of acquisition from 1990 to 2003 by source country.

Sources: Thomson Financial; Bank of England.

The national sources of FSFDI also vary considerably across the target regions (Graph 2). In Latin America, Spanish and US banks accounted for about 80% of cumulative investments. Spanish banks, in contrast to US firms, have a clear regional focus on Latin America and play virtually no role in the other areas. The same is true for many of the western European banks that have invested in CEE. Five euro area countries account for about 70% of the cumulative investment in this region. In Asia

[8] For a discussion of FSFDI in the EU accession countries, see Baudino et al (2003)*.

[9] FSFDI in Asia is discussed in Chua (2003)*, Coppel and Davies (2003)* and Hirano (2003)*; see Hishikawa (2003)* for an overview. For a detailed case study on Korea, see Kim and Lee (2003)*.

globally active banks from the United States, the United Kingdom and the Netherlands, but also foreign private equity funds, are among the largest sources of FSFDI.

1.2 Driving forces

The origins of the surge in FSFDI lie in the financial liberalisation and market-based reforms that occurred in many EMEs in the 1980s and 1990s. These reforms permitted more competition and resulted in fewer controls on credit, interest rates and international transactions. Thus, they enabled a freer play of market forces in EMEs. The reforms themselves were fostered by the general climate favouring privatisation, deregulation and reliance on market mechanisms, the gradual erosion of the effectiveness of and policy support for capital account regulation, and the influence of international financial institutions in promoting greater integration into the global economy and more robust domestic financial systems.

Liberalisation created new market opportunities. A historically more limited competition in many local markets had engendered relatively high margins, especially in activities outside wholesale lending and trade finance. Business lines such as retail banking and brokerage, securities trading, derivatives and other capital market activities provided opportunities to introduce new products and services and to earn relatively high returns, in particular for those firms that were among the first to enter the market. At the same time, risks appeared more manageable as improvements were made to financial systems and to the legal, regulatory and market infrastructure and as market forces received more scope to shape outcomes.

Financial crises and the need to (re-)establish functioning banking systems created a one-time set of opportunities to invest in financial institutions and to expand business in EMEs in the second half of the 1990s.[10] A standard response to crises by EME governments, encouraged by the international financial institutions, was to accelerate financial liberalisation and to recapitalise banks with the help of foreign investors. This was the case in Latin America in the years following the 1994 Mexican crisis.

Similarly, after the collapse of communist regimes in CEE, a period of financial liberalisation ensued until the mid-1990s. In some instances the unsatisfactory results of early domestic privatisation schemes led the authorities to rely on foreign resources to recapitalise their banking sectors. In other cases, the perceived benefits of a better capitalised banking system in combination with fiscal constraints prompted countries in CEE as well as in Latin America to privatise most of their banks in the late 1990s and permit foreign ownership. This process can be regarded as having been largely completed in nearly all CEE countries.

Following the Asian crisis, governments expanded the scope for foreign ownership. Foreign participation in the financial system increased in crisis-hit countries.[11] However, comparatively sound fiscal positions accommodated policies that did not involve foreign investors in the recapitalisation of failed banking systems, in particular the establishment of government-owned asset management companies to deal with non-performing loans. In some cases, limitations remain on the share of foreign ownership permitted and the number of years such ownership can be maintained.[12] Thus, Asia remains less open to FSFDI activities than other regions.

As investment opportunities and risks in the emerging markets changed, heightened competition in their traditional markets increased pressure on major international banks to find new areas of growth. Historically, the main motivation for financial institutions to extend their services abroad was to assist their home country customers in international transactions. In the 1990s, financial institutions in advanced economies increasingly searched for profit opportunities with favourable risk-adjusted

[10] For a discussion of the strategies pursued in the different regions, see Hawkins and Mihaljek (2001).

[11] For a discussion of the experience of the ASEAN countries over the last decade, see Chua (2003)*.

[12] For instance, foreign ownership in locally incorporated banks is restricted (eg in Malaysia) or foreign participation has to be reduced after a certain period (eg in Thailand and the Philippines).

returns at the customer and product level. FSFDI gained importance as a means for accessing local markets that were seen as offering attractive strategic opportunities to expand.[13]

Improvements in risk measurement and management facilitated the expansion by financial institutions into EMEs. In part, investing institutions had gained experience in quantifying and managing market and credit risks using standard frameworks. In part, revamped macroeconomic policy frameworks and a greater reliance on market forces may have aligned the character of EME-related risks more closely with those in mature economies.

Box 1

Quantifying FSFDI – concepts and issues

Following the general definition of FDI,[1] FSFDI is international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in a firm resident in another economy. Hence, it refers to control rather than a specific form of financing.

FSFDI *flows* capture the financing that is related to establishing a significant degree of influence over a financial firm in an emerging economy. One issue in quantifying FSFDI is to determine which flows are related to the establishment of a significant degree of influence on the management. This can usually be assumed to occur when a foreign firm acquires an equity stake large enough to allow the acquirer to influence (or determine) corporate decisions. However, this threshold cannot be readily applied to measured capital flows. Often incremental purchases of equities sum up to a majority stake.

Another issue is the sectoral classification of flows.[2] Some countries provide a sectoral breakdown in their balance of payments statistics. But data on FSFDI flows that are comprehensive and methodologically consistent across countries are not available. Given this limitation, analyses of financial FDI flows often (and also for graphs 1 and 2 in this report) rely on data on mergers and acquisition (M&A) activity. M&A data are based on the announced M&A transaction value, irrespective of how this is being financed. This differs from FDI data generated for balance of payments purposes. For example, M&A data do not capture greenfield investments (which account, in many countries, only for a minimum part of FSFDI). Consequently, FSFDI data generated on the basis of balance of payments transactions and M&A are not directly comparable, although they display similar trends.

An alternative approach, which emphasises the corporate control resulting from FSFDI, is to gauge the *stock* of capital held by foreign banks or their share in financial intermediation in the host country (in particular the share of banking assets held by foreign banks). This concept includes both foreign acquisitions and newly established operations. Again, the issue of the threshold of foreign control arises. Frequently (as in Table 1 of this report) studies assume ownership of 50% of outstanding equity as the threshold for control. However, this assumption can produce misleading impressions since there are many instances where foreign shareholders may exert effective control at lower thresholds.

[1] See IMF (1993) and OECD (1996). [2] The classifications of the IMF and OECD include a sectoral breakdown of FDI and international investment positions (IIP). The relevant categories for FSFDI are "banks" (IMF) and "finance, real estate and other businesses" (OECD). However, sometimes FDI statistics reflect the sector of holding companies instead of the economic sector to which the parent company belongs, according to OECD recommendations. In these cases a reclassification could help to assess the actual economic sector involved. For instance, the preliminary result of such a reclassification for Spain is that direct investment of "financial sector or banks" was undervalued by 56% for the period 1997-2001 (see Duce (2003)*).

Investing institutions had developed capabilities that could be applied to new businesses in EME markets. Techniques for risk management, such as credit scoring, could be adapted to EME environments as standardised client information could be made available and used for evaluation. Further, many investing institutions had developed advanced approaches for managing operational risks that could also be the basis of competitive advantage in often risky EME markets.

Thus, FSFDI promoted several broader trends in the financial industry. First, the trend towards global consolidation; second, the trend towards ownership of banking and other financial institutions at the

[13] Econometric studies find that profit opportunities in the destination market have become the key factor in determining the pattern of foreign bank shareholdings. See eg Focarelli and Pozzolo (2001).

parent level by private shareholders, where the shares are widely held; and third, the spreading of effective competition and market-based pricing.

1.3 The changing character of foreign bank involvement in EME financial systems

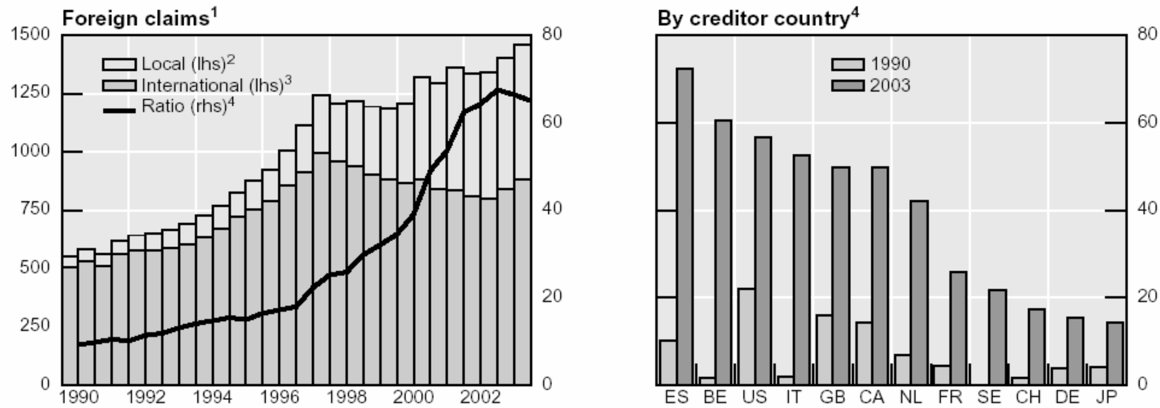
The emphasis on risk-adjusted profitability led to a greater diversity of strategies among foreign financial institutions. The interviews conducted by the Working Group underline the variety of investor attitudes. Most acquirers associated long-term profit opportunities with markets that had the potential for strong income growth, sufficient scale and a strengthening infrastructure. Another, smaller group of firms viewed FSFDI as a means of entering a market with new products and services and remaining until the market matured and relatively high profit margins were competed away. Moreover, legacy investments apparently still account for some of the observed pattern of foreign ownership.

Major international banks identified opportunities that involved a much wider range of business strategies (eg retail, derivatives, and securities trading in addition to the traditional trade and wholesale credit). To some extent, the businesses targeted for expansion in the EMEs reflected the strategies among the major banks and securities firms in their home and global markets.

One main feature of the changing strategies is the increasing emphasis on local markets in EMEs. BIS statistics show a strong increase in local claims in local currency of BIS reporting banks since the second half of the 1990s (Graph 3, left-hand panel). For several home countries, local claims in local currency have become almost as important as international claims (Graph 3, right-hand panel).

The greater diversity of strategies has been associated with a broadened range of banks operating in EMEs. Globally active banks that see EMEs as an important segment of their (established) global franchise have in many cases focused on specific products or clients. In addition, commercial banks, some with a regional focus and some with a specific business strategy (such as mass retail banking), have expanded into EMEs as an extension of their home markets. These firms seem to emphasise economies of scale considerations, often reinforced by a lack of opportunity to expand in their home markets.

Graph 3 **Foreign bank claims on EMEs**



[1] In billions of US dollars; semiannual data. [2] Claims booked by the foreign offices of banks in the BIS reporting area vis-à-vis residents of the country in which the foreign office is located and denominated in the local currency of the borrower. [3] BIS reporting banks' cross-border claims in all currencies plus their foreign offices' local claims in foreign currencies. [4] Local claims as a percentage of international claims.

Source: BIS.

New strategies allowed institutions to exploit economies of scale, for instance in product development, transaction processing, back office and control functions as well as risk management. Such activities are often consolidated for the whole organisation or for regions and centralised, generally outside the host country. A more intangible potential source of economies of scale, a well known global brand name, may be important as a means to establish and maintain relationships with clients. The change in strategies is also reflected in the organisation and size of foreign-owned financial institutions in

EMEs. The establishment of subsidiaries through the acquisition of local banks became the prevalent mode of foreign entry in the 1990s.[14] Typically, subsidiaries possess the branch network necessary to enter retail banking in EMEs. Branches, which constitute a relatively small share of FSFDI, are typically active in wholesale business. Furthermore, investing institutions sought to make investments that were sufficiently large to obtain a critical mass, in particular when entering retail markets. The interviews conducted by the Working Group suggest that investors perceived the legal form of a subsidiary as sufficiently flexible to implement a variety of business strategies (see also Box 2).

Table 1

Ownership structure in the banking systems of EMEs[1]

Country	1990			2002[2]		
	Domestic		Foreign	Domestic		Foreign
	Private[3]	Government		Private	Government	
Asia						
China	0	100	0	98		2[4]
Hong Kong SAR	11	0	89	28		72
Indonesia	…	…	4	37	51	13
India	4	91	5	12	80	8
Korea	75	21	4	62	30	8
Malaysia	…	…	…	72		18
Philippines	84	7	9	70	12	18
Singapore	11	0	89	24	0	76
Thailand	82	13	5	51	31	18
Latin America						
Argentina	…	36[5]	10[6]	19	33	48
Brazil	30	64	6	27	46	27
Chile	62	19	19	46	13	42
Mexico	1	97	2	18	0	82
Peru	41	55	4	43	11	46
Venezuela	93	6[7]	1[7]	39	27	34
Central and eastern Europe						
Bulgaria	…	…	0	20	13	67
Czech Republic	12[5]	78[5]	10[5]	14	4	82
Estonia	…	…	…	1	0	99
Hungary	9	81	10	11	27	62
Poland	17[7]	80[7]	3[7]	10	17	63
Russia	…	…	6	23	68	9
Slovakia	…	…	0	9	5	85

[1] Percentage share of total bank assets. 2002 figures for central and eastern Europe: percentage share of regulatory capital. [2] Data are shown for the latest year available, which is mainly 2002. [3] Calculated as residual. [4] 1999. [5] 1994. [6] Average of 1988-93. [7] 1993. … = not available.

Sources: National central banks; national supervisory authorities; Hawkins and Mihaljek (2001); Cardenas et al (2003)*; BIS calculations.

[14] Evidence gathered by Working Group members supports the notion that banks have been increasingly relying on subsidiaries for their EME operations. In Latin America the number of new operations established as subsidiaries increased sharply between 1994 and 1998, (see Gallego et al (2003)*). For seven CEE countries, the ECB finds that foreign subsidiaries account for more than 60%, and in some countries even almost all, of the foreign banks (Baudino et al (2004)*).

While operating through a branch or a subsidiary importantly depends on the business strategy, the legal form of operation is often also influenced by other factors. Some countries restrict the establishment of branches but allow subsidiaries, while others, through regulation, make branches closely resemble subsidiaries.[15] Many countries require deposit-taking or securities business to be conducted through a subsidiary. Moreover, acquiring domestic banks and establishing subsidiaries was the natural form of entrance in the context of the privatisation or recapitalisation of the banking system.

In addition to changing the composition and strategies of foreign investors, the 1990s boom in FSFDI has significantly altered the structure of financial systems in EMEs. Overall, the share of assets held by foreign banks has increased considerably (Table 1). The regional differences in FDI flows are also reflected in the share of assets that foreign banks hold in different regions and countries. Foreign ownership of the banking sector is substantially higher in Latin America and CEE than in Asia. In several countries foreign banks nowadays control more than 50% of their banking system's assets. In Mexico and the Czech Republic the share of assets owned by foreign banks is as large as 80%. Banking systems in some smaller countries such as Estonia and Slovenia are almost fully foreign-owned.

2. The benefits of FSFDI

2.1 The transformation of acquired financial institutions

FSFDI transforms the acquired[16] financial firm into a part of an international (or global) financial organisation. The provision of new capital is one element of this transformation. The characteristic feature of FSFDI is, however, the transfer of ownership and managerial control. From this viewpoint, the medium- and long-term effects of FSFDI are primarily the consequence of the ongoing transfer of know-how, the integration into the processes of the parent organisation and the global market for corporate control. The actual degree of integration depends on bank-specific factors such as the legal form and the business model (see Box 2).

Access to resources of the parent organisation. Foreign ownership usually involves the transfer of human capital on both the managerial and the operational level. Examples include the assignment of staff as well as the training of local management and staff. Complementary to this is the transfer of "soft" infrastructure such as back office routines or credit control systems. Such transfer has gained importance as banks seek to integrate their EME operations into the overall strategic framework and management of the firm and to reap economies of scale through standardisation of processes.

FSFDI can also involve the "transfer" of reputation. Reputation effects may begin with the announcement of an acquisition by a foreign financial institution. More is put at risk when the acquired bank operates under the parent's brand name. While reputation can be an important asset – in particular when trying to establish and deepen client relationships in retail markets – it exposes the foreign parents (and their shareholders) to the risk of changes in perceptions of its commitment to and performance in EMEs.

Access to parental resources is of particular relevance in crisis periods. In the case of a subsidiary (as a separate legal entity), the parent's liability and obligation to support the local operation is de jure limited to the invested capital, while for branches the parent's capital may be the more relevant measure of resources.[17] However, experience suggests that, de facto, the decision to support an EME

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[15] Examples include imposing capital adequacy, asset pledge requirements or single obligor limits.

[16] The same general considerations apply to greenfield investments. In this case, FSFDI *establishes* an institution in the host country with characteristics basically comparable to those that an acquired banking operation obtains through the *transformation* discussed here.

[17] The liability or support from the parent to operations in EMEs may also be limited through "ring fencing" provisions.

operation ultimately depends on an assessment of the costs and benefits for the group, including factors such as reputation risks or the potential loss of franchise value.

Integration of decision-making. The second, related set of changes associated with the acquisition by a foreign firm is the integration of decision-making and risk management of the local operation into that of the parent. In theory, strategic decisions, including those on broad risk management parameters such as overall country risk exposure, are centralised at headquarters while day-to-day responsibilities remain at the local level. In practice, however, the degree of integration varies considerably and depends on institution-specific factors such as the business focus and the firm's internal culture governing delegation of decision-making of the bank.

The strategic adjustments after an acquisition often include specialising the foreign operation in the host country market. Frequently, acquired institutions become more focused and reliant on the domestic market than they were before their acquisition. The parent institution may at times prefer to book all international assets in the home country or in a regional centre, and will thereby remove international assets from the local balance sheet. Similarly, the parent may seek funding efficiencies by encouraging local funding and consolidating overseas funding in relevant foreign offices. While the group as a whole may become more diversified, the acquired institution may lose international diversification of assets, liabilities and income sources.

Box 2

Foreign bank strategies in EMEs in the 1990s – the role of the legal form of entry

Subsidiaries became the prevalent legal form of foreign bank entry into EMEs in the 1990s. The shift to subsidiaries corresponded to a broader variety of strategies of foreign banks in EMEs. This coincidence has led to questions about how the legal form of foreign bank entry matters for the organisation and conduct of operations in EMEs.

A subsidiary is an independent legal entity, with powers set by its own (host country) charter. A branch is licensed by the host country, with powers defined in the parent's charter, and subject to limitations imposed by the host country. The notion of legal separateness underlies the presumptions that a subsidiary is the suitable legal vehicle for standalone operations; coordinated operations, on behalf of the parent bank, presumably are to be conducted through branches.

In the interviews conducted by the Working Group, a number of banks emphasised the close relationship between the choice of the legal form and the nature of their business.[1] In particular, these banks see the legal separation of operations in EMEs in subsidiaries as fully compatible with their business approach, particularly if focused on retail operations. In the case of subsidiaries, strategic decisions are generally taken at the head office but most control functions are bound to remain more within the local management. This corresponds to much of the day-to-day risk management transactions occurring at the local level.

Other banks employ mechanisms or organisational arrangements that result in a closer integration of subsidiaries into the control and risk management process of the parent group than perhaps given by the legal form. One motivation behind such an approach can be a global product-specific business strategy that involves the application of group-wide processes and standards. Another factor can be to control the exposure to reputation risk, especially if the subsidiary employs the parent's brand name.

Taken together, the interview results suggest that the prevalence of subsidiaries as the form of entry in emerging markets in the 1990s may be related to their focus on retail operations. In addition, the legal form of a subsidiary has been the platform for a broad range of organisational arrangements that reflect different degrees of centralisation. Legal separation has apparently provided the scope to define the relationship with the parent in line with the individual business strategies.

For the analysis of FSFDI, this has two implications. First, the legal form provides a useful reference point for the discussion of the general effects of foreign bank entry. However, given the organisational flexibility, a relevant aspect is also the economic considerations with respect to the implementation of a specific business model. Second, given the diversity of investors and strategies, it is important to recognise that the analysis in this report involves a considerable degree of generalisation. Specific conclusions about the relation between actual strategies and the legal form would require a careful case by case examination.

[1] See the summaries of the interviews conducted by the Working Group in Annex 2.

Integration into the global market for corporate control. The acquisition by a global financial institution shifts corporate control to a parent institution that is owned by a large number of individual and institutional shareholders. This might affect the calculus behind strategic decisions in the same way as globalisation does in other areas. Operations in EMEs are increasingly assessed and managed by comparing the risk-adjusted returns with those of a global portfolio of other investments. However, the policy framework for the financial system is often seen as an important instrument to influence and promote economic development and internal equity. Thus, possible differences in the objectives of shareholders and domestic policies can arise as FSFDI increases.

2.2 The efficiency of the financial system and capital allocation

Ongoing improvements in efficiency and price formation in host country financial markets are the most persistent benefits arising from the integration of domestic financial firms into internationally active institutions. The transfer of human capital and new technology as well as the integration into the parent's decision processes result in modifications of risk management and business (in particular lending) practices and product innovation. The evaluation of business success through global equity markets increases the incentives to adjust business according to its expected profitability on an ongoing basis.

Heightened competition as promoter of efficiency. Heightened competition spreads the efficiency-enhancing effects of foreign bank entry across the financial system.[18] Declining costs or increasing productivity is a documented pattern in banking markets after foreign bank entry.[19] At the same time, profits do not rise. One interpretation is that foreign banks apparently often reserve more aggressively against bad loans, reflecting a risk-based assessment of loan quality and a more disciplined credit culture. Another interpretation is that clients benefit through lower prices and greater access to credit. The two explanations are consistent with enhanced efficiency of the domestic financial system.

Improved credit allocation. Enhanced efficiency in the host country financial system should lead to better allocation of credit. One aspect is the reduction of related-party lending. Foreign-owned financial institutions replace other considerations in the credit decision with the application of formal credit standards and risk-adjusted pricing. This reduces (or eliminates) subsidisation of activities that might not be viable on market terms, reduces moral hazard and avoids the build-up of implicit contingent liabilities on the balance sheet.

There is no firm empirical support for an often expressed concern that the credit standards employed by foreign-owned banks reduce credit to specific sectors, namely small and medium-sized enterprises (SMEs) – sometimes known as "cherry-picking". Some studies find that large banks tend to assign a smaller share of their portfolio to SMEs and that smaller firms are less likely to borrow from foreign banks.[20] There is also evidence that foreign banks do not discriminate against SMEs.[21] Moreover, a number of studies have documented the benefits for the host country economy as a whole stemming from the presence of foreign banks.[22]

Country-specific factors seem to play an important role in determining foreign bank lending to specific sectors. Differences in the access to relationship-related credit information is one explanation.[23] On the one hand, foreign banks may have advantages in transactions lending because of better access to

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[18] Increasing competition should eventually cause domestic banks to adjust their prices. Narrower interest margins are indicative of such an adjustment. However, domestic banks respond to heightened competition also in more subtle ways, for instance by adopting business practices of foreign banks. Such adjustment is also encouraged and facilitated by the transfer of auxiliary services (legal, accounting etc) often associated with foreign bank entry (see Pomerleano and Vojta (2001)).

[19] See eg Claessens et al (2001), Claessens and Laeven (2003) and Martinez Peria and Mody (2003) for cross-country studies. Country studies discussed by the Working Group are Kim and Lee (2003)* for Korea and Bank of France (2003)* for the case of Poland.

[20] See Peek and Rosengren (1998), Strahan and Weston (1998), De Young et al (1999), Berger at al (2001).

[21] See Escude et al (2001) and Bank of France (2003)* for a case study on Poland.

[22] Clarke et al (2001), using data from a global survey of firms, find that in countries with higher foreign bank participation firms of all sizes are less likely to identify high interest rates and access to long-term loans as obstacles to growth. Berger et al (2004) find that in developing nations larger market shares for foreign banks are associated with better economic performance in terms of faster GDP growth, and higher bank lending to GDP ratios.

[23] See Nini (2003)* on the relationship between foreign and local banks in providing syndicated loans to emerging market borrowers.

information technologies for collecting and assessing hard information. The use of standard credit scoring has probably facilitated expansion of foreign banks into household lending. On the other hand, foreign banks may be disadvantaged in relationship lending to informationally opaque SMEs because of difficulties in using soft information.[24] From this viewpoint, the behaviour of foreign banks would be indicative of shortcomings in the legal or accounting infrastructure and should be of concern to both foreign and domestic banks.[25]

In any case, changes in lending policies by foreign-owned banks cannot be viewed in isolation when assessing their effect on credit availability for SMEs. Even if foreign banks focus on specific market segments, increased competition in these markets appears to induce other domestic banks to channel resources to other parts of the economy while they begin to look for new creditworthy clients. Foreign banks also induce improved credit availability by enhancing the stability of the banking sector.[26]

Incentives to develop local financial markets. Entry by foreign financial institutions may also support the development of financial markets in host countries. Foreign financial firms have both the incentives and the expertise to develop certain segments of local markets, such as funding, derivatives and securities markets. The foreign firms often try to create markets or gain market share through product innovation, especially by offering a variety of new financial services to corporate clients, including OTC derivatives or structured products. Foreign financial institutions frequently offer asset management services which, perhaps accompanied by rising national income and pension reform, add to the demand for financial assets, in particular tradable securities.[27]

Foreign financial firms also seek to develop domestic financial markets that can assist them in managing their local exposures. Hedging markets in EMEs tend to be underdeveloped, perhaps with the exception of hedging markets for currency risk. However, interviews revealed a preference on the part of foreign banks to hedge local risks in domestic markets when possible. Incentives to promote financial market development exist in particular with respect to local funding markets (eg the interbank market or the market for bank debt securities) and the management of interest rate and currency risks. Foreign financial firms often provide technical advice in creating new markets or modernising existing ones. Finally, foreign institutions may contribute to improvements in the legal framework and the financial infrastructure, including accounting standards and auditing practices.

2.3 Financial and macroeconomic stability

The injection of foreign capital via FSFDI into the financial system of EMEs has been most important in the aftermath of financial crises in Latin America and the privatisation of financial systems in CEE.[28] FSFDI also contributes to financial stability in the host country in the medium and long term by improving the management of risks and by enhancing the capacity of the system to absorb shocks.

[24] Berger et al (2004).

[25] For instance, in some countries in CEE the availability of credit is attributable to the lack of collateral and credit records.

[26] Bonin et al (2003) suggest that foreign ownership produced a more stable banking sector in some countries in Latin America and CEE, at least compared to their experiences just after their initial bank privatisation. In addition, those authors point to the positive post-privatisation performance of banks in Hungary, the first country in the region to embrace foreign ownership.

[27] Another example is foreign insurance companies that invest premium revenues from host country policyholders in local financial markets (see Schembri (2003)*).

[28] In a number of countries, FSFDI represented, at least temporarily, a substantial and, relative to the size of the banking sector, disproportionate share of capital inflows. Baudino et al (2004)* cite the example of Poland, where FSFDI temporarily accounted for about one third of total FDI. The overall effect of FSFDI on international capital flows, and hence the capital account, is complex and difficult to assess. FSFDI can be expected to trigger a broad range of other financial transactions which may have an ambiguous impact on capital flows. One example is the substitution of cross-border lending by locally funded domestic lending, which would ceteris paribus reduce statistically recorded net capital inflows. Another possibility is that FSFDI induces additional inflows, for instance because it is seen by other investors as a positive signal regarding the profitability of investments in the host country. Taken together, any comprehensive assessment of the financing effect of FSFDI would have to take into account the medium- and long-term impact of foreign bank entry on financing patterns and economic performance of the host country.

Empirical results are consistent with the view that foreign banks contribute to the resilience of the host country's financial system.[29]

Enhanced overall soundness of host country financial system. The introduction of the risk management practices of the foreign parent enhances the overall soundness of the local financial system. More aggressive measures by foreign banks to address asset quality deterioration point to tighter credit review policies and practices that may help to limit the build-up of non-performing assets in the financial system.[30] To the extent that foreign entry encourages the adoption of risk-based practices in lending and the management of loan portfolios, it contributes to the reduction of concentration of exposures and prompter resolution of problems.

In addition, foreign institutions possess incentives to work actively to make the financial system sounder and more secure in order to mitigate their own risk. One example is the introduction of new products, such as OTC derivatives, that can be used to hedge risks and assistance in developing the legal, accounting and regulatory infrastructure to support a new market.[31] Another is the promotion of innovation in clearing and settlement systems that reduce operational risks.

Foreign institutions can also be a catalyst for regulatory changes in the EME's financial system.[32] The responsibility for the supervision of foreign-owned financial institutions can provide incentives for upgrading supervisory knowledge, especially when the foreign-owned institutions undertake innovative activities.

Reduced sensitivity to host country credit cycles. The ability to manage credit risk together with stronger capitalisation, access to market or parent funding and diversification of the parent's risks tends to make foreign banks less sensitive to both home and host country business cycles. Consequently, lending to local residents in the local market is likely to be more stable in times of stress than either cross-border lending or the lending of indigenous banks in the markets. Research also supports the notion that foreign bank presence smoothes the host country's credit cycle.[33]

Stabilising influence in crises. Foreign-owned institutions may also exert a stabilising influence in times of financial distress. Stronger capitalisation, and the possibility of an injection of additional funds by the parent, if needed, reduce the probability of failure. The existence of banks that continue operating in a crisis increases the probability of the system as a whole remaining functional.

The local presence of foreign-owned banks that are perceived as "safe" can further reduce financial fragility by absorbing the domestic capital flight within the local financial market, thereby moderating capital outflows and larger financial pressures often observed in episodes of market distress. Traditionally, a "flight to quality" in an EME translated into capital flight, in the absence of trusted institutions in the domestic financial system. When such trusted institutions operate in the host country, a flight to quality may still occur as capital flows to those institutions, but without the balance of payments effects that add to exchange rate and interest rate pressures.

The possibility that foreign-owned financial institutions will limit "flight to quality" episodes is not certain, however. Government action can vitiate this benefit, as in Argentina, where initially foreign-owned banks received deposit inflows, but then experienced massive withdrawals once depositors became concerned that foreign banks could be discriminated against. Moreover, if foreign banks become increasingly concerned about political risk (or country risk more generally), they may reduce domestic assets and liabilities, putting pressure on domestic markets and possibly exerting pressure on the capital account.

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29 Demirgüç-Kunt et al (1998) find foreign bank presence to be negatively correlated with the occurrence of banking crises. The authors draw the conclusion that greater foreign bank participation has a stabilising effect.

30 See Crystal et al (2002).

31 See Goldberg (2003)*.

32 Schembri (2003)* mentions the role that a foreign insurance firm played in drafting regulation governing insurance in China.

33 Clarke et al (2002) find that the variation of bank claims on the private sector relative to GDP declines with increasing foreign bank participation in a country. Baudino et al (2004)* show similar results for the EU acceding countries. De Haas and Van Lelyveld (2003) find that especially foreign banks with greenfield investments have contributed to stability in credit supply in the EU acceding countries.

In discussing these factors, it is important to recognise that well capitalised, managed and trusted domestic banks can be expected to exert a similarly stabilising influence as foreign banks. Hence, the broad lesson is that healthy banks are key for financial stability. Whether these are foreign-owned or domestically owned is of second-order.

3. Risk management issues for financial institutions investing in EMEs

3.1 Changes in the management of FSFDI-related risks

Improvements in the risk environment in EMEs, together with advances in the risk management techniques available to foreign investors, have affected the way FSFDI-related risks are assessed and managed. The capacity to better assess, quantify and manage the risks has facilitated the integration of EME operations into the day-to-day and strategic risk management of global financial institutions. In addition to the day-to-day management of market and credit risks in EMEs, financial firms aggregate risks within individual countries to manage country risk, subject to the broad parameters determined by the strategic risk management process.

Day-to-day risk management. The better macroeconomic performance, increased liquidity of host country financial markets, and greater reliance on market forces to determine prices in EMEs have probably contributed to risks in EMEs becoming analytically more comparable to those in advanced economy markets, while often still exhibiting higher variances and fatter tails. Market, credit and ordinary liquidity risks associated with the operations in EMEs are increasingly managed within a group-wide framework using common risk assessment techniques.

The management of exposures associated with day-to-day business is typically delegated to the local operation. This allows banks to exploit the specific opportunities for risk management that physical presence in local markets offers. These opportunities reflect information generated by frequent contacts with borrowers and other local market participants and a more intimate knowledge of host country markets and processes in general. Such knowledge should facilitate credit evaluation and monitoring. Another element is the availability of risk mitigation techniques. Certain techniques, such as posting collateral, may exhibit a higher degree of legal certainty if lenders and borrowers are domiciled in the same jurisdiction. Moreover, a foreign firm can, by establishing a local balance sheet, run a matched book in terms of currency exposures.

While a local operation enhances the capacity to manage financial risk, it also introduces new risks.[34] The business environment in EMEs may entail larger operational risks because of the state of legal and financial infrastructure and the lack of certain skills among financial sector employees.

Managing financial and operational risks is a major challenge in times of economic strain or acute crisis. The combination of a sharp decline in business activity and financial market volatility may result in cumulating and reinforcing credit and market losses. Under severe circumstances, foreign banks may be confronted with (potential) losses that exceed the capital of their local operation in the respective country, and the question of whether to exit altogether. For this reason, day-to-day risk management is supplemented by an overlay of country risk management.

Strategic risk management. Progress in managing day-to-day risks in EMEs has also affected the strategic management of FSFDI. The capacity to apply group-wide techniques for the assessment of risks has been an important precondition for the implementation of client- and product-specific strategies in EMEs. The emergence and spread of risk management techniques, including those designed to quantify the impact of low-probability, high-cost events, have facilitated the application of standard measures of profitability – such as risk-adjusted return on equity – to EME investments and the stress testing of profitability under a variety of scenarios.

The progress in assessing EME-related risks together with structural reforms in EMEs have increased the liquidity of FSFDI. Liberalisation and deregulation in many EMEs were the precondition for the

[34] For a discussion of the risks associated with FSFDI, see Gallego et al (2003)*.

buying and selling of participations in local financial firms for foreign investors. The enhanced capacity to quantify the value of operations in EMEs and to apply standard benchmarks of performance has spurred the integration of EME financial institutions into the global market for corporate control.

Greater liquidity should add to the willingness to assume exposures through FSFDI – a view that is supported by the broader and more diverse investor base that emerged in the second half of the 1990s. Moreover, the interview results indicate that some investors pursue strategies that rely on the premise that investments can be resold. These investors often emphasise restructuring and efficiency-enhancing measures that increase the net present value of a firm over strategies that involve a long-term commitment of the parent groups. Generally, greater liquidity has broadened the room for manoeuvre for both foreign and domestic investors.

New strategies, however, have also increased the costs of exiting a country. In valuing their EME investments, institutions regard their local operations as a bundle of assets – including intangible elements such as licences, host government goodwill and local and global client relationships – that are costly to acquire and abandon. Operating in domestic markets for many years leads to the creation of firm-specific franchise value such as customer and supervisory relationships, an understanding of regulatory treatment and a reputation – assets that have gained in value with an increasing focus on local business and that are lost when exiting the country. This puts more emphasis on gradual, but perhaps more frequent strategic adjustment within a country.

One factor that raises the likelihood of exit for all groups of foreign investors is country risk, and in particular political risk, the risk of unanticipated adverse government action. Such action reduces or even removes the "government goodwill" element in the franchise value of foreign operations. Reducing operations or exiting the country rather than recapitalising becomes a rational decision if the cost of the government actions exceeds the long-run net present value of the operations. But even then, the issue of client relationships and the legal ability to "walk away" remains.

This stands in contrast to the impact of a cyclical downturn in the economy which left the long-term prospects for the country intact. If the reason for the capital loss is an economic downturn or mismanagement on the part of the bank, a recapitalisation by the parent company could be viewed as indicating an expected increase of future cash flows. Recapitalisation in such a case would probably represent a means to limit reputation risk. The same arguments hold for branches to an even greater extent, since branches are an integral part of the home country financial institution. These considerations underscore the importance of country risk for the management and the outcome of crisis episodes.

3.2 Managing country risk

Country risk, and particularly political risk, is the key risk to manage for financial institutions in EMEs: it is highly correlated with other risks, and it is particularly hard to hedge.[35] Country risk in the context of FSFDI involves the possibility that conditions in or actions by a country will reduce or eliminate the ability of a foreign financial institution to receive the full benefits of direct investments in that country. In general, government actions or failures to act will be the proximate cause of that inability, whether through the imposition of exchange controls, the failure to maintain civil order or the expropriation of foreign-owned property.

Key role of political risk. Political risk is the risk of a low-probability and high-cost event that involves a national government, by legislation or fiat, either gradually or abruptly diminishing property or creditor rights. An expropriation is an example of such an extreme event. Arbitrary or discriminatory interpretations of laws and regulations could be a substantially milder version of this effect. Other measures such as elimination of FDI incentives – for instance subsidies – or the introduction of domestic ownership requirements may also adversely affect franchise value.

Discretionary government action can affect the profitability, liquidity and/or capital position of foreign financial institutions in other, unforeseeable ways. Any assessment of the potential effects of adverse political risk outcomes is complicated by the fact that political events often both result from and amplify

[35] Empirical work suggests that country risk has become even more important after recent crises. Wezel (2004a)*, in analysing the determinants of FDI by German banks, finds that variables of country risk gained in significance after the Asian crisis.

deteriorating macroeconomic circumstances. Consequently, losses associated with a political act are often compounded by credit and market risk losses. Recent events in Argentina illustrate the potential for sovereign actions to affect banks' balance sheets (see Box 3). An increase in such a risk can alter the risk-return calculus that led to the original investment.

Box 3

The Argentine crisis as a manifestation of political risk

Starting in 1998, the Argentine economy suffered a series of adverse shocks, and entered into a prolonged recession. Over the course of 2001 investor confidence deteriorated amid persistent economic contraction and a series of policy missteps. By end-2001, a government debt moratorium was officially declared. The currency board was abandoned in early 2002 and restrictions were imposed on further access to depositor savings.

The government's reaction to the worsening economic and financial conditions was a sequence of measures that eventually involved changes to existing contracts. Some of the measures sought to stabilise deposit flight and to protect the banking system from the crisis. Banks' liquidity requirements were reduced to assist banks in meeting initial deposit withdrawals. When this proved insufficient, the government imposed restrictions on deposit payouts and capital controls to avert the collapse of the weakest institutions. These measures brought the payments system to a standstill, and broadened depositor distrust to include prior safe haven institutions, including foreign banks. [1]

The asymmetric pesofication of highly dollarised bank balance sheets resulted in a disproportionate decline in the value of bank assets and corresponding equity losses. [2] Other measures designed to protect borrowers (such as suspensions of the enforcement of judicial foreclosure procedures) and depositors (particularly court rulings restoring depositor rights to full original dollar value on their frozen deposits) reinforced perceptions that normal banking activities could not be conducted.

Foreign banks, which accounted for about 50% of Argentine bank assets on the eve of the crisis, reacted with different strategies. Several banks opted to exit. In some instances, banks that abandoned the country in response to the crisis did so in the context of a larger reorientation of their international activities. In other instances, banks with a clear regional strategy maintained their presence, reducing their activities in line with the behaviour of local privately owned banks. [3]

The large losses by foreign banks and the changes in the rule of law have influenced the assessment of FSFDI in EMEs. Some lessons:

- Large losses can arise from unanticipated government policy decisions. In this regard, the Argentine case is particularly troubling given the strong build-up in institutional strength and supervisory capacity that occurred in the years prior to the crisis.
- Foreign bank participation may create a moral hazard for authorities facing difficult policy choices and represent a target for discriminatory treatment. Foreign banks reported relatively larger losses, in part reflecting greater supposed loss-bearing capacity. This underlines the importance of equal treatment of foreign and domestic banks.
- Regardless of how the foreign operation is structured legally, exit from a market under stress can be costly, reflecting financial, legal and reputational issues.

[1] For a more detailed discussion of the Argentine crisis, see de la Torre et al (2002). [2] In the absence of pesofication, bank credit losses would have also been high, as substantial currency depreciation was fully passed on to foreign currency borrowers. While banks were in autumn 2002 compensated for pesofication-related losses through the receipt of government bonds, changes in the "rule of the game" such as pesofication were damaging investor confidence. [3] On the experience of one Canadian bank, see Murray (2003)*.

Country risk management often employs scenario analysis. Stress tests estimate the maximum loss that would be sustained from an adverse event. Many institutions have added an expropriation scenario to their stress tests, and some institutions which had stress tests for country risk have reconsidered the underlying assumptions. Stress testing of country exposures had already become more stringent after the Russian default and became even more so after the experiences in Argentina.

A crucial decision in evaluating stress tests is whether the maximum loss supports a decision to largely exit a country or a business continuation scenario in which additional capital or funding may be made available from the parent. In evaluating potential losses, the maximum loss from closing or abandoning an operation may be much higher than the amount of capital invested due to a loss of the value of intangible assets.

Business and risk managers have also reconsidered strategies to reduce the maximum potential loss, once it is determined. One risk mitigation strategy is to make a timely business reduction (but not closure) in a country when political risk exceeds some threshold. Another strategy tries to match assets and liabilities geographically (supplemented in some cases by geographic matching of revenues and costs). A third strategy lies in tightening the decision criteria when deciding on new FSFDI investments. These and other strategies to insure against political risks potentially involve high costs in the form of forgone profits. Additional social costs can occur in the form of suboptimal allocation of resources, if the political risk is overestimated and FSFDI is suppressed.

3.3 Instruments to manage country risk

Non-deliverable forwards and credit derivatives. Two instruments designed specifically to address country risk are increasingly tradable: non-deliverable forwards (NDFs) and credit derivatives.[36] An NDF is an offshore forward foreign exchange contract that does not require physical delivery at maturity.[37] NDFs permit investors to manage foreign exchange rate risk in countries where a liquid currency market does not exist, including many countries where potential capital controls represent a significant currency risk. Credit derivatives are financial instruments with payoffs depending on the materialisation of prespecified “credit events” (such as default, restructuring, or moratorium) that adversely affect the expected value of a reference asset.

The principal issues credit derivatives have faced in financial disturbances have been disagreements on the interpretation of definitions of ”credit events” triggering payoff and in the case of NDFs on establishing post-event contract values. Experiences such as the Russian default in 1998 and the Argentine crisis have resulted in considerable sharpening of definitions and price determination processes. The Argentine crisis represents the most recent test of these instruments. There is general agreement that contract improvements reduced the difficulties around the Argentine default relative to the Russian default.

To expand the liquidity, depth and breadth of the risk transfer markets in EMEs, the underlying cash markets would need to develop increased liquidity and depth. For example, to develop a larger credit derivatives market, EMEs would need to develop a larger, more liquid corporate securities market. As a country gravitates towards investment grade, the risk transfer markets tend to have more room to grow, probably converging with the broader global markets for foreign exchange and credit derivatives. In fact, the NDF market often largely disappears when countries remove all capital controls and increase their integration in the global financial system. Mexico is a case in point.

Political risk insurance (PRI). PRI is designed specifically to mitigate political risk. PRI provides insurance against loss of asset value due to politically related events – typically currency inconvertibility, expropriation, or political violence. For example, a financial institution may insure an equity investment in a foreign subsidiary against the risk that dividends cannot be repatriated due to currency restrictions imposed by the host government. PRI coverage is offered both by private insurers, who typically are affiliated with large, multi-line insurance companies, and by national and multilateral public insurers.

Only a small fraction of total capital flows to EMEs is protected by PRI. Although risk sharing is the raison d’être of most lines of insurance, the large financial intermediaries engaged in FSFDI tend to be active in many product lines and in many regions of the world; thus, they are already naturally diversified. Moreover, banks by the nature of their operations have expertise in addressing challenges that arise with risk sharing, including information gathering, monitoring, and other contracting issues. Thus, for them the value added in PRI from risk sharing may be small. Our interviews revealed that many are tending increasingly to self insure against political risk.

[36] On the use of country risk transfer instruments by US financial institutions see Dages (2004).

[37] Usually, the settlement is in US dollars while the other currency is an EME currency subject to capital controls.

In addition to risk sharing, PRI is believed to provide a so-called “halo effect,” a term that refers to the political influence that the insurer may have on authorities of the host country and the potential implications that may have for the prospects of the insured project and for financial recovery in the event of problems. Although not always made explicit, this component is thought to be prominent in PRI offered by many public providers (eg the World Bank’s Multilateral Investment Guarantee Agency). Private insurers also seem to offer a version of the halo effect that probably stems from participation in multilateral coalitions (eg the Berne Union) that can be sponsored by public initiative. The halo effect in PRI seems to be especially appealing to smaller institutions, where demand for PRI is evidently stronger.

Contracting problems associated with political risk may prevent wider use of PRI. Political risk events tend to be somewhat sui generis and complex, making it difficult to arrive at a clear ex ante specification of the coverage under a PRI contract. In practice, contracts tend to cover only a limited range of possible causes of loss, and insurers confronted by claims have argued that the range is even narrower. The fact that few PRI policyholders have been compensated so far in the wake of the crisis in Argentina has led many to question the value of the product. In other financial markets where analogous problems have appeared (eg credit default swaps), an accumulating record of events seems to have helped improve the design of contracts – suggesting that PRI may benefit from more experience in a similar fashion. In another approach, both buyers and providers of PRI referred to growing interest in contracts with more comprehensive coverage that might overcome the problem of sharply defining a political risk event. If start-up costs are preventing either type of contract innovation, public insurers may serve a role by incurring this cost.

4. Issues for authorities in charge of financial stability and public policy

4.1 Functioning of the host country financial system

The integration of a domestic bank into a global organisation – in terms of risk management, decision making and corporate control – raises issues of differences in the objectives of the parent bank and the specific needs and conditions of host country financial systems. One question concerns the manner in which banking activities are conducted. A separate issue is whether foreign control deprives host country supervisors and markets of important information about domestic financial market developments.[38]

Centralisation of risk management and specialisation of the local operation. Many local control functions, such as risk management and credit approval, are often integrated into the global control framework of the financial institution. While responsibilities for the conduct of day-to-day business remain with the local management, strategic decisions migrate to the bank’s headquarters. In theory, this increases the dependence of the host country financial system on decisions of the parent. In practice, the relevance of the issue depends on the character of delegation to branches and subsidiaries and the importance of the individual bank’s operations for the host country financial system.[39]

Parent banks could make changes in business strategy or risk appetite that can have major impacts in host country markets, but for which country considerations are marginal for the parent. The foreign parent could decide to reduce operations in a country in a manner that restricts the availability of financial services in a way that is inconsistent with local economic and financial conditions or that, in the extreme case, damages the host country’s banking and financial markets. Such spillover effects could be particularly harmful when the foreign parent experiences severe financial stress or fails, or when the home countries of several parent organisations experience financial pressure.[40]

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[38] For a discussion of issues related to foreign bank entry, see Cardenas et al (2003)*.

[39] See Sveriges Riksbank (2003) for the case of Estonia, where two subsidiaries of Swedish banks account for 91% of total banking assets.

[40] On spillover effects through common lender effects, see van Rijckeghem and Weder (2003).

Integration into an internationally active group often also involves specialisation of the activities of individual units. Greater specialisation of local operations would matter if the local operation was left more vulnerable to shocks. In many cases, better capitalisation and access to parental support can be expected to compensate for a potential loss of diversification benefits. In addition, the local operation would probably benefit from specialisation in terms of its operational efficiency and domestic risk profile.

Specialisation might become a concern if the local operation were to lose support from the parent institution and would have to face associated problems on its own. In such a case international diversification of assets could mitigate the impact of shocks on the local operation. Decentralised funding in international markets would probably only be of limited use if parental support was lost in a crisis. Under crisis conditions, it is unlikely that a separate local entity would access international markets.

Migration of corporate control and loss of information. Integration may be associated with a loss of information if the foreign parent decides to delist its subsidiaries on local exchanges. As a result, equity market signals are no longer available; the banks no longer file disclosure statements; and, perhaps even more importantly, judgments by bank analysts, who examine banks' financial information and disseminate their assessments, disappear.

The disappearance of market information may render the monitoring of developments in the host country financial system more difficult. This includes the assessment of the performance and risk profile of the foreign-owned banks themselves as well as the systemic relevance of their activities. Especially when foreign operations dominate the market, information about their linkages with and exposure to other parts of the host country financial system (eg the interbank market activities, the role as counterparty in host country financial markets) could be relevant from a systemic perspective.

Several mechanisms are conceivable – and in some cases already used – to generate substitutes for this information. Host country supervisors could require publication of information submitted to them, much as the call reports are required to be published in the United States. Alternatively, foreign financial institutions' disclosures and equity analysis for the larger foreign operations in EMEs could be made available; currently the information provided appears to be either absent or insufficient for a thorough analysis. A third possibility is to impose local listing requirements. A fourth approach is to encourage or require the issuance of subordinated debt in the local market. Whether to employ one or more of these mechanisms is an issue of striking an appropriate balance between the cost of generating local information and the benefits to market participants and financial authorities.

Host country supervisors usually obtain a considerable amount of information and can require additional information. The publication of such information that is already available to host country supervisors, in particular balance sheet and income statements, could provide a useful starting point for the assessment of both firm-specific and systemic risk. However, other information about the activities of foreign banks in the domestic financial systems in EMEs, such as their risk management practices, would often require specific additional disclosure requirements.

Regulatory disclosure requirements cannot fully substitute for financial market signals. Market prices should in principle incorporate all information for the valuation of a firm's debt or equity on an ongoing basis. However, in the case of a subsidiary, market prices would to some degree reflect market assessment of the financial linkages with the parent. Local equity prices would not only reflect the expected profitability of the subsidiary, but also expectations about the parent's dividend policy and capital support more generally. And the expectation of parent support to the subsidiary might be priced into the local debt price. Notwithstanding this, the existence of tradable local instruments could create a starting point for investment analysts to monitor subsidiaries.

Issuing local debt, and hence generating signals in host country financial markets, is the more attractive (or, in case of mandatory issuance of local subordinated debt, the less costly) for financial institutions the more liquid the local market is. However, the incentives to issue local debt securities also depend on the funding and risk management practices of the foreign bank. If the subsidiary already taps host country financial markets for funding, the issuance of local debt might be more consistent with the group's approach than in the case of cross-border funding through the parent.

Local equity listing requirements raise the issue of the compatibility of local listing with corporate control through global equity markets. Designing a proper host country institutional and regulatory framework has far-reaching ramifications. One is defining the rights of minority shareholders in a way that does not undermine market-based corporate control. Another question is how to ensure active trading in the local market.

4.2 Concentration

The impact FSFDI has on concentration in the financial system is crucial to assessing the relevance of possible adverse effects on home and host country financial systems. From the viewpoint of the host country financial system, market concentration and its effect on domestic competition are a major issue. From the perspective of international financial stability, concentration of exposures to specific home or host countries may be a pathway for the propagation of financial crises.

Market concentration in host country financial systems. Cross-border mergers and acquisitions have been be one of several factors contributing to an increase of concentration in the financial systems of some emerging markets. However, there is no conclusive evidence that greater concentration has reduced competition in host country financial systems.[41]

The key issue is whether concentration is associated with or followed by the opening of the financial system for potential competitors. The possibility that new competitors – not necessarily banks, but also other providers of financial services – can enter the host country market should discipline incumbents. From this viewpoint, higher concentration might be a transitory phenomenon that reflects the evolving nature of deepening host country financial systems. This underlines the relevance of a policy and institutional framework that encourages entry of new competitors, both domestic and foreign.

Concentration in the exposure of host countries to foreign banks. Foreign institutions can be a source of contagion from events taking place somewhere else, as they serve as transmission mechanisms for the policies adopted by their stockholders in response to shocks in their home country or in third places where they have investments. High concentration in terms of the location of parent institutions increases the host country's exposure to spillover effects from changes in the conditions of the home market of one or more of these institutions.[42] An adverse shock to a home country could propagate in the host country economy through a reduction of activity of the foreign operations or, in extreme circumstances, the failure of a parent institution. Such risk can, in principle, be reduced if foreign participation comes from various countries that are not closely interrelated.

But common risk factors, and hence high risk concentration, with respect to foreign investors might emerge independently from the location of the parent. Internationally active banks may, even if headquartered in different countries, be exposed to the same shocks if they pursue similar client- or product-specific strategies.[43] Finally, large swings in global equity markets, for instance resulting from an abrupt change in the risk aversion of equity investors, might trigger strategic adjustments of a broad range of financial institutions.

Concentration of exposures to EMEs. For a number of banks, EME operations account for an important share of assets and profits. In the interviews conducted by the Working Group, views differed as to the importance of risk diversification in their investment decisions. Several mentioned the advantages brought by the diversification of either risk or revenue streams. Others emphasised the broadening of customer bases or growth exposures, or the complementarities with the home market business.

Whether diversification benefits materialise depends first of all on the capacity of the investor to identify and assess common risk factors in EMEs. This is already challenging with respect to economic factors such as risk correlations arising from the sectoral structure of different countries or the macroeconomic framework. It is even more difficult to assess if investors see a country as exposed to political risk.

[41] Gelos and Roldos (2002) analyse a number of banking markets, including some in developing countries. They report that, overall, banking markets in their sample have not become less competitive, although concentration has increased. For a review of the literature on the effect of foreign bank entry on concentration, see Claessens and Laeven (2003).

[42] Goldberg et al (2001) found that the onshore and offshore exposures of US banks to emerging market economies were more responsive to economic conditions in the United States than to emerging markets growth and interest rates.

[43] Following the same line of argument, one can question whether a joint host country is an indication of common risk exposure. Banks with the same home country may pursue strategies that involve quite different risk characteristics.

4.3 Financial sector supervision

As local banks and other financial companies are absorbed into foreign financial institutions, the information needs of the authorities in charge of financial stability change. The rapid expansion of FSFDI in the 1990s created a need to ensure that EMEs were fully involved in the information sharing among authorities in charge of financial stability. More generally, the additional complexity introduced by the expansion of banks' operations into EMEs, the competitive dynamics in global markets and the potential relevance of EME operations to the risk assessment of equity holders and creditors of the parent underline the benefits of cooperation for both home and host country supervisors. Such cooperation could also be instrumental in ensuring equal treatment between foreign-owned and domestic banks.

Enhancing the know-how of the authorities in charge of financial stability. New strategies by acquired banks may present new challenges to supervisors and create opportunities for greater interaction between home and host country supervisors. For example, in some markets, foreign-owned banks have contributed to a rapid expansion of consumer lending and of foreign currency lending to both households and businesses. This situation carries potential risks for the stability of the financial system, for instance in the event of sudden exchange rate movements. Therefore, supervisors may need new tools to assess how such credit programmes are managed by the banks, and authorities in charge of financial stability may need new information and techniques to monitor for vulnerabilities in the financial system.

The authorities responsible for financial stability need to be alert to institutional arrangements that may create new financial market vulnerabilities. Policies that lead market participants to underestimate risks over an extended period (eg exchange rate regimes that resist market forces) represent highly relevant examples of such vulnerability. Another area that has created problems in several countries is regulatory requirements to allocate a large percentage of the balance sheet of financial institutions to local government debt. A further case in point concerns measures by the authorities and foreign owners to contain risks by differentiating between local and international business in private contracts and regulation. The identification of vulnerabilities introduced by new activities or strategies represents an additional challenge to financial authorities. For central bankers, this may be an area where expanded exchanges and workshops could yield beneficial insights.

In other cases, stress testing can be useful in assessing vulnerabilities. For example, where foreign currency or consumer lending is growing rapidly, stress tests or scenario analyses can explore whether the growth and pricing of lending are compatible with the balance sheet and income characteristics of the sectors borrowing.

The new strategies and products that foreign-owned financial institutions bring to EMEs can be a catalyst for developing the skills of staff in institutions in charge of financial stability. Some of the transfer of new knowledge and technical know-how can occur through cross-border information sharing between these authorities; another channel for transfer is through technical assistance. The BIS and the Basel Committee created the Financial Stability Institute to provide advanced training for management and staff in EME financial authorities.

Information sharing among institutions in charge of financial stability. The tendency of many large financial institutions to organise along global business lines reduces the natural flow of information to host country supervisors as risk information is often aggregated at the head office and business decisions such as credit approvals are sometimes made outside the host country.

Home country supervisors and financial institutions should recognise the impact of parent bank problems on particular EMEs when the operation is a large presence in the local market. Similarly, central banks need to be in close contact when a parent bank's problems appear likely to affect substantially the local subsidiary or branch. In such circumstances, it is crucial that the home central bank understand the liquidity situation for the institution as a whole, and that the host country supervisors have sufficient information to make decisions if they need to respond to liquidity dislocations in their markets.

Information sharing among supervisors is also relevant when parent institutions make decisions based on a re-evaluation of business strategy or risk appetite that could impact the host country's banking and financial system. The first burden of communicating such changes lies with the financial institution, but the home and host supervisors could usefully share their perspectives. Similarly, authorities in both the home and the host country need to understand the significance of such strategic or risk decisions and their ramifications for the stability and liquidity profile of institutions in their markets.

The possible failure of an investing institution also raises well known problems of conflicting laws, multiple jurisdictions, preferential treatment of some claimants, and legal uncertainty that are under study in the context of cross-border insolvency of financial institutions. The character of these issues depends on the legal form of the operation. While this subject goes beyond the scope of the current project, it is worth noting that as EME jurisdictions become involved in cross-border insolvencies of financial institutions, they add to the complexity of the legal and procedural issues and should be involved in the continuing discussion of cross-border insolvency-related issues.

The Joint Forum in a series of papers in the late 1990s outlined a set of principles for information sharing for financial conglomerates.[44] The management trends it documents and the supervisory principles it sets out are applicable to all large, complex financial institutions. These principles counsel that host countries should share information without hesitation with home country supervisors so that the home country supervisors can provide effective consolidated supervision. Home countries should be forthcoming with host countries about issues involving a financial institution operating in that country, especially when the financial institution has a major presence in the host country. Finally, both home and host supervisors should be proactive in seeking information from one another when they see issues or have questions. In addition, the Joint Forum has described information needs that occur in emergency situations.

These principles of information sharing, while designed for monitoring risks at individual institutions, are also relevant for considering the impact of financial institution difficulties on markets and on financial stability more generally.

As the Joint Forum work discusses, information sharing, especially in the face of financial distress, requires trust. It recommends that to build such trust, it is necessary to widen the opportunity for interaction among parent and host country authorities in "normal" times. The Basel Committee and the Joint Forum have taken steps to increase the participation of emerging market authorities in charge of financial stability, but the scale of FSFDI in the 1990s suggests that these efforts could be beneficially increased further.

4.4 Incentives for maintaining a path of financial liberalisation

The trend over the last two decades in the developed countries and EMEs alike shows expanding financial liberalisation, greater openness and increased competition. Within advanced and emerging countries alike, important questions remain about the appropriate ownership of financial institutions: state versus private, closely versus widely held, domestic versus foreign. In addition, questions remain about the appropriate sequencing of capital account liberalisation and financial sector development.

Financial systems around the world are increasingly driven by market forces, enabled to a substantial extent by a trend towards an ownership structure for large banks that can be described as widely held holdings of relatively small ownership shares by the public. And from a public policy standpoint, enhancing the incentives for emerging market governments to absorb the costs of adjustment towards a more market-driven system has substantial long-term benefits. The Working Group identified several arenas in which opportunities exist to build on recent experiences.

Codes and standards. The development of codes and standards by major international bodies, among them the IMF, the Basel Committee on Banking Supervision, IOSCO, the OECD and the Committee on Payment and Settlement Systems, is intended to provide EMEs with guidance in developing a sound financial system. Assessments by the IMF and World Bank in the form of Financial Sector Assessment Programs (FSAPs) and Reports on the Observance of Standards and Codes (ROSCs) are intended to provide more information to the market about the underlying strength of the financial system in EMEs with the expectation that the market rewards countries for high levels of compliance.

Anecdotal evidence suggests that compliance with codes and standards has had some modest impact on leading edge investors. While most FSFDI investors do not seem to give much weight to

[44] See Joint Forum (1998).

compliance with codes and standards per se, compliance may have an indirect impact on factors, such as financial and economic stability, that FSFDI investors consider important. Hence, a strong causal linkage between compliance with codes and standards and FSFDI may not emerge in empirical studies. Moreover, the Working Group noted that the codes and standards effort has much broader goals than promoting FSFDI, and the effort is still at an early stage.

While progress on codes and standards compliance is one factor that improves the environment for FSFDI, strengthening the legal framework may be more essential to the relevant investors. The need to strengthen property rights, creditor rights and the insolvency regime(s) for corporations and for financial institutions is well recognised. Several international efforts are under way to provide guidance to all countries, such as UNCITRAL's model bankruptcy law, now beginning to enter legislation in several advanced economies, as well as ongoing work on insolvency regimes sponsored by the IMF and World Bank. Unfortunately, the work on bankruptcies only occasionally covers issues associated with cross-border bank insolvencies. Hence, more work on this issue is called for.

Multilateral funding or political risk insurance. A second possibility to strengthen incentives is to mitigate risk through the provision of multilateral financing or political insurance. In the 1990s, private risk capital for FSFDI appears to have been plentiful for projects in larger, healthier emerging market countries. Because of that, a key question in shaping a role for multilateral finance or risk insurance is to identify a policy objective for official financial support for FSFDI, that is, a market failure or externality that public policy should address.

The Working Group sees a potential role for public intervention in the market to encourage initial FSFDI entry into poorer countries, where political risk may be higher. In those countries with poorly developed financial sectors or weaker regulatory, legal and political systems, FSFDI may generate significant positive externalities (some of which may also reduce political risk). The subsidy mechanism in PRI to encourage such entry, however, must be structured and priced carefully to conform to its objectives and to minimise undesired side effects.

Regional compacts. A final set of arrangements that may offer incentives to EME governments to develop a robust legal, accounting and regulatory framework and maintain it even in economic difficulties is various forms of regional compacts. Some of the major compacts examined by the Working Group include the European Union and its accession process, NAFTA, Mercosur and ASEAN.[45] The evidence so far remains qualitative and anecdotal, but suggests that further careful study is warranted.

Structural reforms in EMEs have clearly been encouraged by prospective or current benefits of regional compacts. For example, as a precondition for membership of the European Union the transition economies in Europe adopted a body of EU legislation and developed market-based institutions and policies, thus creating a stable legal and economic environment that no doubt encouraged FSFDI. Mexico's entry into NAFTA, as well as macroeconomic policies pursued by the Mexican authorities, have played an important role in attracting substantial amounts of FSFDI. Thus, economic development through strong regional economic ties and expanded free trade zones may have the potential to provide the prospect of benefits to EMEs large enough to encourage their sustained commitment to policy and legal norms.

Such regional compacts may also facilitate regional capital and financial market integration. In the European Union, the development of a single goods and services market followed by the adoption of a single currency by many member countries has been the main mechanism to promote more integrated capital markets. Consistent with increased integration, cooperation among national financial supervisors is being enhanced.[46]

But capital market integration is possible without necessarily adopting a common currency; a common set of listing and disclosure requirements, a common legal, accounting and regulatory framework, and freedom of capital flows may be major steps to develop the scale economies and attract the risk capital necessary for a vibrant financial market. Larger, more liquid capital markets would offer the

[45] See Rueda-Maurer (2003)*.

[46] Memorandums of understanding on high-level principles of cooperation between banking supervisors and central banks of the European Union in crisis management situations were concluded in 2003.

additional benefit of allowing FSFDI investors to hedge their investments more effectively by issuing local liabilities to fund their local assets.

It may be worthwhile to consider the economic benefits of other forms of recognition and whether they provide sufficient incentives to EME governments. For example, an investment grade rating or accession to the WTO could mean lower borrowing costs and better access to foreign capital.

5. Conclusions

FSFDI has been instrumental in the integration of EME financial sectors into the global financial system. Important structural and regulatory changes within EMEs, in combination with expansion of the global market for corporate control, have been major driving forces behind this development. Among other things, growth of FSFDI has reflected the efforts of investing banks to integrate EMEs into their market- and client-specific strategies and to exploit economies of scale. As a result, EME financial systems now include a broader range of financial institutions with diverse strategies. The integration process has also given rise among potential investors to more rigorous evaluations of the expected profitability and risk of doing business in EMEs.

At the firm level, many of the benefits of FSFDI for host countries come from the transfers of technology and related expertise that typically occur within an integrated firm – such as extension of better risk management and risk-adjusted pricing to markets where previously they were only imperfectly applied. Similarly, host country customers benefit directly from new financial products and services that FSFDI introduces. At the industry level, FSFDI generates widespread ongoing benefits, as foreign participation raises the efficiency of host country financial systems by exposing local operations to global competition. At the macroeconomic level, FSFDI also typically brings needed balance of payments finance. Given the stronger capitalisation and better risk management associated with FSFDI, it has most probably contributed on balance to greater financial stability in host countries as well.

The expansion of FSFDI has brought substantial benefits, but it has also brought to the forefront two issues for host country authorities in charge of financial stability. One is to explore whether, and in what ways, the growing global integration of the host country financial systems has changed the exposure to shocks that arise from external economic, financial and strategic developments. A second issue is to ensure that authorities and market participants have adequate information to assess the conditions in the host country financial system. As highlighted in this report, the availability and quality of local financial information may be of particular relevance in this context. In addition, the mutual benefits of greater cooperation among home and host country supervisors are compelling in this context because of the additional complexity introduced by the expansion of banks’ operations into EMEs.

The Working Group’s research, including its interviews with market participants, revealed that investing institutions have made considerable progress in upgrading their risk management capabilities – especially in the aftermath of the recent problems in Argentina. They have also become more sensitive in their strategic planning to the consequences of country risk, as experience has involved extreme events that severely damaged the franchise value of operations in EMEs. In part because risk management tools, including specialised market instruments, provide at best only limited protection, absorption of country risk is, for the most part, internalised by investing firms.

Country risk can be difficult to hedge against, but there are some fundamental steps that can be taken by a host country to improve its risk environment and make it more conducive to FSFDI. Prominent among these is a commitment by host country authorities to policies that foster economic growth and stability. Another is the adoption and prompt implementation of international financial codes and standards. Likewise, strengthening domestic legal frameworks is an essential step to reduce country risk. Because many of the benefits of FSFDI depend on the effective functioning of the market for corporate control, measures aimed at achieving closer conformity of local accounting standards, takeover rules, and bankruptcy codes with international counterparts are also especially important.

There are some additional public policy steps that can speed up the process of global financial integration. Participation in compacts aimed at regional integration of financial systems, often within frameworks for broader economic integration within the region, can be an important step towards this objective, as demonstrated by countries’ experiences under the European Union and NAFTA. Some poorer countries may merit special public policy support to promote capital inflows and growth; for them, political risk insurance provided by public or multilateral insurers – if properly designed – could be helpful in encouraging more FSFDI.

How should future progress be measured? Because the ultimate yardstick is the contribution that a more efficient, globally integrated financial system makes to economic development and prosperity, such measures ought to be linked closely to the benefits of FSFDI and the factors that generate them. Hence, measures of progress ought to focus on the strength of the institutional and regulatory framework of host country financial systems, the degree of integration of the financial system in the global market for corporate control, and the capacity of investors and authorities overseeing financial stability to assess and manage risk.

Annex 1

Mandate of the Working Group

The Working Group "Foreign Direct Investment in the Financial Sector" explores issues related to foreign direct investment (FDI) primarily in the financial sectors of emerging market countries. The project seeks to identify the financial characteristics of foreign direct investment today, to compare them to those of other forms of financing, and to develop policy implications for the effective functioning of financial markets and for financial stability. The areas of focus would include:

- The asset price sensitivities, risk management considerations and incentive issues associated with FDI.
- The impact of institutional arrangements (eg exchange rate or regulatory regime) on the nature of FDI-related risks.
- The assessment and management of such risks by foreign banks and other major foreign investors in the financial sector.
- Possible implications for international capital flows and for public policy goals such as the effectiveness and stability of financial markets within countries and the promotion of a sound global financial system.

Annex 2

Summary of the interviews conducted by the Working Group

In spring 2003 the central banks participating in the Working Group conducted interviews with 40 financial institutions (commercial banks, investment banks, insurance firms) with operations in emerging market economies (EMEs). The survey sought to understand the motivations, necessary conditions and other factors that affected financial system foreign direct investment (FSFDI) in EMEs. Interviews further aimed at developing insights into the surge of such investment in the 1990s, the recent decline in flows, and the prospects for FSFDI. In addition, the interviews sought to understand how banks assess and manage associated risks, and, in particular, the development of banks' use of risk management tools. Questions were organised in three broad groups: business strategy, risk management, and a general evaluation of FSFDI in EMEs. This summary highlights main findings.

Business strategy

The interview findings point to a general evolution of FSFDI in EMEs towards strategic choices based on the likelihood that global product- or client-specific strategies can be successfully deployed within a country. This shift in motivation appears to reflect a long-term reassessment of "country"-based strategic approaches in the light of experiences with different emerging market crises. Notwithstanding this broad trend, legacy investments and institution-specific factors continue to play an important role in explaining EME presence.

High expected profit margins – reflecting better growth prospects and/or less competition than in developed markets – in specific markets were cited as the main motivation for expansion into EMEs. Global economies of scale on the product level were of minor importance as services offered in emerging and developed countries differed. However, they seem to be more important with respect to the standardisation of infrastructure and processes. The actual investment approaches of institutions often differed in practice and apparently reflected perceptions of comparative advantages and the extension of established business lines and areas of expertise into new markets. To some degree EME investments were also seen as offering diversification of earnings and assets.

Notwithstanding the importance of such broad strategic rationales, to a notable degree, decisions by banks and other financial institutions to invest in emerging markets in the 1990s were driven by unique factors. Many participants noted that their investments in the past decade reflected in part "one-off" factors, including the wave of privatisations that occurred in many countries at this time.

The primary goal of effective managerial control determined organisation of operations in EMEs. Control, which was referred to as being essential in protecting the parent's brand, was achieved by operating in the form of branches or by full, or at least majority, ownership of subsidiaries. Generally, host country regulation was emphasised as a major factor when deciding on the legal form of representation. For instance, subsidiaries were in many cases required if banks wanted to take domestic deposits. Several participants highlighted the importance of the nature of the business, the capital needed, expansion strategies, or the type of funding as major determinants of the choice of the legal form. Others questioned whether the legal differences between branches and subsidiaries, including limited liabilities, mattered in practice. Finally, institutions generally regarded the legal form of their investment in emerging market financial sectors (eg branch versus subsidiary) to be of uncertain utility in mitigating risk, with the choice of legal form generally driven by local regulations or other business.

Risk management

Participants assessed financial risks in EMEs as generally larger than in developed countries. This was attributed to less liquid domestic markets, larger fluctuations in economic activity, more frequent episodes of economic and financial crisis and more substantial country risk in general. Higher legal and operational risks as a consequence of incomplete legal frameworks or a lack of enforceability of contracts and weaknesses in financial infrastructure were also mentioned. Some participants emphasised that the reputation risk associated with EME investments had increased over the past couple of years. In particular, several participants commented that strategic withdrawals in the aftermath of the Argentine crisis were considerably influenced by considerations of reputation risk.

Hedging opportunities in financial markets were generally characterised as limited. Currency risk could be hedged at relatively low costs, while other financial risks were often very costly to hedge because of poor liquidity of markets, if these existed at all. Most institutions generally sought to include “risk mitigants” in emerging market transactions wherever possible, including principally the use of collateral and contractual legal protections in transaction documentation (including contractual language providing for different types of recourse – for example, margin requirements or acceleration clauses – specified by the “triggering” of events or thresholds that indicated increased risks). Several participants also emphasised the importance of running a matched book or taking positions that generated potential offsetting profits.

Risk transfer instruments are regarded by most institutions as of only limited importance in managing balance sheet risks. This reflects limitations in the scope of risks covered by such instruments and the limited depth of the product markets. Participants expressed great interest in further exploring credit derivatives, but noted only very limited current utilisation due to insufficient liquidity and other technical factors. Additionally, continuing uncertainty regarding the applicability of “restructuring clause” language and the relatively small standard contract sizes limited their applicability as a general tool to manage country risk. The market has attempted to address shortcomings revealed in earlier episodes of market disruption although there appears to be residual uncertainty. Political risk insurance was characterised, with few exceptions, as being of limited value. Only specific aspects of political risk, such as transfer risk, could be hedged. Difficulties also existed with respect to assessing political risk.

The institutional framework for approaches to risk management exhibits similarities across institutions. Generally, risk management is embedded in the global strategy of the parent company. Risk committees were key elements of the risk management process, and included representation of key business lines and risk managers, with frequent meetings to review portfolio risks. Country conditions and global exposures are regularly and actively reviewed. Broadly, market and credit risks are managed in a common framework applicable globally, with country risk management acting as an additional set of constraints.

Risks are typically measured in terms of potential losses with respect to particular products and business lines, with individual risk exposures aggregated to determine total “country risk.” Institutions are also focusing increasingly on more severe or worst case loss scenarios. As a result, institutions are relying more upon comprehensive stress test approaches to quantifying potential losses. Additionally, institutions appear to be increasingly examining “qualitative” risk factors – including, in particular, legal and political risk factors – with the view that traditional approaches to transfer risk assessment are too narrow to encompass the full range of business risks in emerging markets.

The Argentine crisis was cited as a clear example of the difficulty in anticipating the wide-ranging actions that host governments can take during a crisis and of the danger in relying upon limited definitions of potential risks. While the 2002 actions in Argentina had in most cases not fundamentally changed the views concerning the potential attractiveness of FDI, it had changed the perception of risk. Partly as a consequence of this, risk definitions now generally anticipate the potential that losses on emerging market FDI may exceed the value of equity invested and view market- and credit-related risks as very interconnected.

General evaluation and outlook

Financial institutions have closely examined their strategies toward EMEs, including FDI, following the 1997-98 financial crises and the more recent experience in Argentina. Common themes include a reassessment of the risk characteristics of emerging markets, greater differentiation among individual emerging markets, and an overall conclusion that country fundamentals are an important factor in determining future financial sector FDI flows into emerging markets. Several mentioned absence of critical mass, lack of prospects, and possible implications of the New Basel Capital Accord as factors lying behind exiting countries.

Banks emphasised the need to meet specified targets for the risk-adjusted return on equity or comparable measures of business success. Shifts in strategic focus stemming from domestic merger activities, as well as intense pressures on bank share prices were cited as creating greater urgency for banks to adjust their strategies to achieve a higher risk-adjusted rate of return. Against the background of tougher competition, the medium-term path appears likely to feature selectivity towards investments in emerging market financial sectors and, in particular, a continued focus on the assessment of the profitability of particular clients and products rather than on the establishment of market presence per se as a strategic objective.

A limited number of institutions that enjoy comparative advantages (in scale, funding cost, product expertise or otherwise) may be able to capture superior returns by consistently capturing the most profitable and best risk profile client opportunities within particular countries, while other institutions pursue more opportunistic or "niche" opportunities. Pressures from financial markets may also figure importantly here.

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