Foreign direct investment in the financial sector - experiences in Asia, central and eastern Europe and Latin America

Summary of follow-up workshops to the CGFS report, “Foreign direct investment in the financial sector of emerging economies”

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Introduction

In March 2004, the Committee on the Global Financial System (CGFS) published a report entitled *Foreign direct investment in the financial sector of emerging market economies* (the Cumming Report).¹ The report discusses how the surge in financial sector foreign direct investment (FSFDI) over the past decade has been instrumental in integrating emerging economies into the global financial system. On the one hand, integration has brought substantial benefits to host countries’ financial systems in terms of efficiency and stability. But, on the other hand, it has also brought to the forefront issues related to the management of country risk and the assessment of conditions in host country financial systems. The report also looks at risk management issues for investing financial institutions as well as for authorities in charge of financial stability and public policy in general.

At the same time, the report acknowledges notable differences in the involvement of foreign-owned financial institutions in the financial sectors in emerging Asia, central and eastern Europe (CEE) and Latin America. Recognising the potential relevance of regional factors in the assessment of FSFDI, the CGFS organised follow-up workshops to explore issues raised in the CGFS report with a broader range of central banks in these three regions. The workshops were held in Seoul (hosted by the Bank of Korea), Mexico City (hosted by the Bank of Mexico) and Warsaw (hosted by the National Bank of Poland) in 2004. They were chaired by Roger W Ferguson Jr, Chairman of the CGFS and Vice Chairman of the Board of Governors of the Federal Reserve System. In total, senior representatives from 37 central banks participated in the workshops (the list of participants is attached), together with a number of representatives from the private sector.

This paper summarises the main findings of the workshops. The document is organised according to the general themes discussed: (1) experiences with FSFDI; (2) issues for private financial institutions operating in emerging market economies; and (3) issues for the authorities in charge of financial stability and public policy. Parts 1 and 3 highlight commonalities and differences in views. Part 2 presents the main points made in separate sessions with the private sector at each workshop.

1. Experiences with financial sector FDI

*Competition and efficiency of host country financial systems.* Intensified competition, improved availability and quality of banking services, technology transfer and easier access to capital were generally seen by meeting participants as the main benefits associated with foreign entry into financial systems. Signs of enhanced efficiency were visible in a number of countries. In Chile, for instance, growing foreign bank involvement had been associated with a declining cost/income ratio. In the Czech Republic, entry by foreign banks, which were significantly stronger than their domestic competitors, had improved risk management. Experiences tended to be positive, especially when financial firms expanded into markets where they had acquired specific expertise and introduced sophisticated risk management techniques.

Foreign banks had promoted the development of financial markets through initiatives that supported the development of a local currency yield curve. Overall, foreign banks had drawn up more nuanced strategies and improved risk management over the past decade or so. In Poland, the presence of foreign banks had increased financial system diversity in terms of participants and products and contributed to deeper financial markets.

Nevertheless, it was not surprising that the discussion highlighted the fact that frameworks in, and the policies of, individual countries had a significant influence on the competition-related consequences of foreign bank entry. Australia, for example, when vetting foreign banks’ subsidiaries in the 1980s, preferred entrant banks which were willing to offer a broad range of products. This stance was biased in favour of foreign banks aggressively competing with domestic banks. The resulting exposure to adverse selection risk led to large losses by foreign banks. In the early 1990s, however, the entrance

¹ See http://www.bis.org/publ/cgfs22.htm.
criteria were changed, with the focus now on whether the bank would bring something unique to the
Australian financial system.

In Korea, foreigners - often private equity funds - had acquired controlling interests in domestic banks
after the Asian crisis. Foreign-owned banks had focused on expanding retail banking. Improving cost
efficiency had been overshadowed by profit reduction. This had been positive as it had reflected a
willfulness to address asset quality problems and to make higher loan loss provisions rather than
reporting profits. However, hopes that foreign banks would offer a wide range of financial services had
not been fulfilled.

The discussions revealed different views on the extent to which economic outcomes were attributable
to foreign participation. One view was that the large-scale entry of foreign financial institutions was a
powerful force for change. In particular, in CEE countries foreign banks were instrumental in the
privatisation of banking institutions and pacemakers for the transformation process. Another view was
that FSFDI was a catalyst for financial sector development rather than a necessary condition for
development. Brazil was cited as an example of where progress was attributable to other factors, such
as the initiative of the central bank with respect to collecting creditor data and improvements in
accounting and auditing standards or in clearing and settlement systems. In some cases, foreign bank
presence had intensified competition only in certain market segments.

The centralisation of decision-making was mentioned as a potential drawback of foreign bank
presence. Technological progress had added to economies of scale and supported centralisation.
Centralisation was also an issue with respect to financial infrastructure. Small countries noted that it
was difficult to generate the critical mass of financial activity necessary to attract firms to develop
research coverage or interest in settlement systems for local markets.

Foreign banks and the allocation of credit. The impact of foreign presence on economy-wide credit
allocation was one key concern raised in all three regions. One aspect was that foreign banks sought
to cherry-pick creditworthy customers. Moreover, they focused on household lending rather than
providing credit to a broad range of sectors. For several Asian countries, this gave rise to doubts about
the role that foreign banks played in the context of the domestic economic development agenda.

A second element was that foreign banks emphasised standardised credit evaluation over lending
based on “soft” information and long-term customer relationships. Consequently, lending to small and
medium-sized enterprises (SMEs) in particular was outside the scope of foreign banks in countries
where such firms were not routinely subject to audit. In part, the business focus of foreign banks
reflected the absence of an adequate legal and accounting framework, which raised the cost of writing
credit contracts with SMEs. But this was not necessarily specific to foreign banks. In the Czech
Republic, for instance, the same lending practice was said to be used by foreign and domestic banks.
However, there were differences in terms of funding as foreign banks could borrow more cheaply in
international markets than domestic banks.

Another theme surfacing during the discussions concerned the implications, for most new EU member
and accession countries, of the rapid credit expansion associated with foreign bank entry, especially
credit denominated in euros. A benign view was that rapid credit growth reflected a catching-up
process as part of the transition that was still under way. Hence, credit growth was occurring from a
low base and in rapidly growing economies, so that the debt burden would remain low. According to
this view, foreign currency lending reflected the specific role of the euro in the integration process.
Another, perhaps less benign, interpretation was that the rapid credit growth was a sign of aggressive
expansion by foreign banks into mass retail lending, supported by the increase in property values.

Were the risk management capacities of financial firms consistent with rapid credit growth? Risk
management in host countries was basically the same as at the parent level. But incomplete legal
frameworks posed challenges, as they were regarded as creating obstacles to using modern risk
management techniques. There was only very limited currency mismatching by foreign banks. But
were borrowers hedged? In small open economies such as Latvia, corporations generated returns in
euros.

Monetary policy and financial stability. The impact of foreign banks on the effectiveness of domestic
monetary policy was seen as ambiguous. On the one hand, more competitive financial systems and
deeper financial markets had reinforced the transmission of interest rate signals, thereby enhancing
the effectiveness of monetary policies. The strengthening of credit allocation worked in the same
direction. On the other hand, strong lending by foreign banks in foreign currency was difficult to control
as it was driven by funding conditions in international markets. However, it was not entirely clear in what way foreign bank presence changed the linkages to global markets.

Views also differed regarding the impact of FSFDI on financial stability. Lending by foreign banks’ offices in Korea had tended to be countercyclical during the post-crisis period. Moreover, depositors saw foreign-owned banks as a “safe haven”, arguably reducing the pressure on the current account. In Latin America, foreign bank entry played a key role in stabilising financial systems after the “tequila crisis”. For instance, Mexico’s post-crisis situation placed it in a position where the overall plausibility of its recovery policy would have been undercut by an unwillingness to accommodate entry by large foreign banks.

One potentially important externality of foreign participation in terms of available information was that sizeable foreign operations were associated with improved macroeconomic and political risk analysis and created a constituency against wide swings in opinion.

The main challenge was the reduction of capital allocated to business in individual host countries by the parent bank. In this context, concerns were expressed that the “deep pockets” of inexperienced foreign banks could amplify asset price cycles through an overextension of credit and banks’ subsequent withdrawal from the market.

Uruguay reported problems with (smaller) foreign banks. All foreign banks experienced a run as such smaller parent banks were closed. It had come to be appreciated that small banks in large home countries might not be systemically important, but problems experienced by them could generate significant spillover effects in smaller host countries.

The Argentine crisis underlined the need to take into account macroeconomic policy choices when assessing foreign banks’ activities. The currency board had created false incentives for currency risk management. Assumptions that the banking system was dollar-hedged proved wrong, as borrowers were not able to service their dollar debt. However, crisis management made a major difference in terms of actual costs.

2. Private sector views

Seoul. The presentation by a representative of a domestic Korean bank highlighted the catalytic role that foreign bank entry had played in the Korean banking sector. As one of the few institutions that had withstood the Asian crisis, this bank had grown stronger through strategic mergers and acquisitions. It had introduced a risk management system and implemented changes in credit evaluation and risk management methodologies. Transparency and expertise in corporate governance had been emphasised.

A foreign strategic (minority) investment in 2000 had provided know-how in insurance and bancassurance and also enhanced the transparency of corporate governance. Moreover, it had been used as a platform for strategic partnership in the establishment of financial subsidiaries. The minority participation was sufficient to exploit the advantages of the strategic partnership. The strategic partner has not been involved in the day to day business.

Another presentation illustrated the implementation of a global customer- and product-specific strategy through FSFDI. The presenter’s institution, a large globally active bank, had become the leading pan-Asian provider of wealth management services. Low credit losses and rising loss absorption capacity reflected rigorous process discipline and diversification. Distribution remained the key competitive advantage in the credit card business. The bank continued to build strategic markets such as India and China. The challenge was to strike an appropriate balance between local depth and global spread. One key element in this was that the franchise value was not dependent on one specific market.

The bank employed various techniques to manage the risks resulting from its foreign operations. Its high loss absorption capacity, the focus on the US dollar and wealth management served as a buffer against cyclical fluctuations. Its key country risk indicator system, mitigating positions offshore and good legal documentation were mentioned in the context of sovereign risk. Diversity across markets and currencies, together with the hedging of earnings where appropriate, were used to manage currency risk. Finally, compliance and a strong audit process led to low operational risks. Good
information and legal infrastructure are necessary to apply many of these techniques, and are a precondition for foreign banks to enter a market successfully.

One issue raised was the role of the investment horizon of foreign investors. One view, emphasising the need for long-term investment, was that strategies driven by the motivation to maximise market value in the short run had undermined the stability of the Korean financial system. Speculative investment had distorted the development of the market. Private equity funds had concentrated on cost cutting and operational improvements. A contrary view was that such investors had played a positive role by cleaning up the balance sheet of the acquired domestic institutions and by driving progress in risk management. This had created the preconditions for takeover by a long-term investor. It was also noted that equity funds only entered a market because there were no other investors. This underlined the importance of functioning markets for mergers and acquisitions as a means to attract more players.

Another issue was the focus of foreign institutions on high net worth customers. Comments emphasised the availability of quantitative, standardised information for credit assessment and management (as opposed to local, often “soft” information) as a precondition for market entry by large foreign institutions. Reference was made to SME lending in the United States, where the size of the lender was a factor, rather than ownership. Smaller banks and specialised markets provided finance to SMEs. Another concern was that the marketing of foreign mutual fund shares would drain savings from host countries. However, it was also stated that this would broaden consumer choice - especially given the low capitalisation of domestic securities markets in Asia - and the opportunity to achieve globally competitive returns.

Mexico City. The “tequila crisis” led to unprecedented foreign participation as local investors were not willing or able to inject needed resources. Hence, Mexico moved from a strategy of a gradual opening of the financial system to one that entailed the foreign acquisition of virtually all major domestic banks. The domestic bank represented at the workshop, backed by its solid position, was able to grow, primarily through acquisitions. Global players opted to buy all of the remaining national banks.

Foreign acquisition had transformed the Mexican banking system. The environment was increasingly competitive. Positive effects were efficiency gains, a greater capacity to innovate, technological transfer, higher capitalisation, sophistication of risk management and the exploitation of economies of scale. Disadvantages were that decision-making had moved to headquarters, so that less information was available to domestic markets. This posed challenges for benchmarking. The host country was subject to global portfolio allocation decisions made by the parent.

Succeeding as the last national franchise in a predatory environment was a big challenge. However, there were also opportunities resulting from advantages in local decision-making and a better knowledge of the market, which allowed the exploitation of niches. Examples of this were the management of distressed assets or business with states and municipalities. But there was a need for continuous self-improvement and the strengthening of corporate governance. Generally, there was ample room for the financial sector in Mexico to grow.

The experiences of a large Spanish bank in Latin America were seen as providing evidence confirming the three main conclusions of the CGFS report. First, there had been greater integration of local operations into the “global model” of the bank. The risk management of operations in Latin America was an integral part of its global risk management. The risk committee of the parent’s board of directors set group-wide risk limits and delegated authorities. Within this framework, only operations with governments and supranationals were decided centrally; all other decisions were decentralised.

Second, strategic decisions to invest in Latin America had created incentives to develop tools to aggregate and compare risks across countries. At the group level, the bank had established an integrated framework for risks, while at the same time providing ample room for manoeuvre for local bank managers to make business decisions at the country level. The framework was used to allocate economic capital to the group and all its units. A homogeneous methodology to assess and quantify risks was key to the aggregation of risk and the development of this common framework.

Third, local operations had improved risk management, but new risks, associated with the evolving structure of the Latin American financial system, were appearing. One important issue was discriminatory practices of host country authorities - between domestic and foreign and/or public and private banks. Another challenge was instability of the regulatory environment. The third was the unsustainable combination of large foreign penetration, low private sector loan growth and high profits
based on fees and commissions. Substantial investment in local risk management suggested that fast growth of credit in the region was the way to resolve this “impossible trinity”.

The company’s experience also shed light on how the Argentine crisis had changed the nature and cost of exit. There was no single model of an exit strategy. What had become more important was legal stability. The value attached to the “legal density” in a country had increased. Exit could be an option in countries that combined legal risks and limited market opportunities.

The presentation by a rating agency representative present at the meeting distinguished three groups of foreign banks active in Latin America: global banks; players with strategic regional focus; and other banks that were not focusing on significantly expanding in the region. The current competitive landscape was one in which most foreign investments had already been completed, with the exception of Brazil. The integration of local operations into the groups had been concluded. The current focus was now on growth and profitability. The operating environment was more benign than in the past. The long-term presence of foreign banks in Latin America was determined by external developments, operating conditions in local markets where banks have operations, and a reduced tolerance of country risk exposure and volatility. Against this background, some banks which viewed Latin America as not strategic were already leaving the region.

The discussion also addressed the issue of how foreign acquisitions and delisting affected the availability of information. It was important to distinguish between information made available to markets and that available to public authorities or rating agencies. For rating agencies, foreign acquisition entailed no change as they had access to public and confidential information, but information available to the markets was affected. Analyst coverage disappeared. With respect to assessments of the condition of the financial system as a whole, the disappearance of bank analysts highlighted the value of analyses by public authorities, such as those performed by the IMF under its Financial Sector Assessment Program.

Several speakers commented on the “impossible trinity”. Large foreign bank penetration and high interest rates on credit cards in an environment of low inflation raised doubts as to whether the trinity was really impossible. Why were spreads so large? One element was risk. Spreads would decline when economic growth picked up. Another was the combination of financial innovation and nascent financial markets. One bank had recently introduced fixed rate mortgages, and hedging positions was expensive. Low lending to SMEs reflected a lack of information rather than an unwillingness to lend as a large share of SMEs operated in the informal economy. Lending would pick up once credit risk management - which had to be developed from scratch - matured.

The challenge for many countries was to keep foreign banks. This was especially an issue for smaller economies, where foreign banks needed to obtain a large market share to be profitable. However, such a large market share in a small economy exposed them to political risk.

Warsaw. The representative of a Polish domestic bank emphasised the positive impact that foreign bank presence had had on the Polish banking sector. Foreign ownership had strengthened competition in the banking market, encouraged new business initiatives and enhanced cost efficiency by facilitating consolidation. Innovation had narrowed the gap between Polish and western European banks. Foreign banks’ activities had also accelerated the development of the capital market, for instance through the establishment of investment funds and asset management companies.

The evolution of the Polish banking sector was reflected in the bank’s new organisational structure and the range of products offered. The company had established a separate distribution network for retail and corporate banking services. The design of new products - eg mortgage loans, insurance contracts, investment funds - and new marketing strategies such as cross-selling or e-banking had benefited from the experience brought by foreign investors.

The bank's net profit constituted almost half of that of the Polish banking sector in 2003, and its non-performing loan ratio was well below the banking sector average. The bank placed its highest value on its customers while maintaining its current leading position in retail banking. It also played a leading role in serving local governments, SMEs, housing loans and EU assistance programmes. The bank stated that it was and should remain a domestic universal bank of Polish character.

The representative of a foreign bank active in CEE compared banking business in the region and in western Europe. Growth prospects in CEE were better than in western Europe, given that financial deepening had just begun. Competition was intense in an environment of buoyant growth of financial assets and the overall economy. However, the macroeconomic and political background in individual CEE countries differed significantly.
It remained to be seen whether the bancassurance model could be successfully implemented in CEE. The banking and insurance sectors were still at different stages of development. Moreover, there were still notable differences in customer behaviour and preferences in CEE and western European countries. In CEE, customers were only slowly shifting from bank deposits to money market or mutual funds, in part still reflecting a lack of trust in the financial sector. The distribution of financial services was less bank-based than in western Europe. Only a small proportion of insurance products in Poland were being sold by banks, and more cars were financed via car dealers than via banks. Finally, cultural differences and different styles of management were also important. Staff were often still hierarchically minded. Big differences existed in terms of sophistication between large corporates, SMEs and individual customers.

One meeting participant discussed the prospects for foreign financial institutions in CEE as follows. Since 1996, the share of financial assets in CEE owned by foreign banks had tripled to 66%. Hence, the scope for further foreign acquisitions was small. Nevertheless, the banking market still had great potential as the economic catching-up process in CEE continued. Deposits and loans were still growing twice as fast as in the euro area; the growth rate of personal loans was even three times as high. The demand for non-bank financial products was rising. In terms of profitability, net interest income and return on assets were higher in CEE than in western Europe. Retail spreads were still higher in CEE, but in some sectors which were already at the same levels as in the euro area considerable scope remained for efficiency enhancement.

It was thought that foreign banks would continue to dominate the banking sector in CEE countries. Any changes would primarily result from strategic changes within the groups. For most of the big foreign players, business in CEE now accounted for a substantial portion of total business volume. The top seven foreign banks in CEE maintained about 20% of their risk-weighted assets in CEE and generated almost 30% of their return on equity there. The market now operated with similar rules to the EU 15, but there were still significant regional differences in the retail business. International banks in the region should nonetheless be able to take advantage of economies of scale.

The discussion raised questions regarding the conduct of credit business by foreign banks. With respect to foreign currency lending, it was necessary to distinguish between corporate and retail customers. Corporate lending was mostly in euros, and mortgage lending increasingly so. But many corporations were euro-hedged, as they generated revenues in euros. The expansion of foreign currency lending in part reflected the trend appreciation of CEE currencies, which reduced the cost of borrowing in foreign currency. From the viewpoint of the exposure of parent banks, foreign currency lending was not a major issue as it represented only a small fraction of total loan books.

Why were spreads in mortgage lending in CEE so close to those in western Europe? One explanation was that mortgages were denominated in euros, which was a highly competitive market. Another aspect was that newcomers aimed at gaining market share with very aggressive pricing.

Which banks would benefit from the existing growth potential in CEE? One view was that the incumbents were in a favourable position. New entrants had to pay a much higher premium than the incumbents, which would make entry into CEE relatively expensive for the big commercial banks. Moreover, there were only a few banks left that could be acquired and experience suggested that greenfield investment did not work in the longer run, especially in the retail business. Finally, the overall size of the CEE market was still small.

3. Policy issues for central banks

This section highlights some of the key policy issues which were raised at the three workshops. No firm consensus was reached among meeting participants, nor among central bank representatives. Nonetheless, commonalities and differences in views were noted. Overall, the discussion of policy issues reflected the underlying notion that FSFDI was generally beneficial. Financially strong foreign banks had improved risk management and, as a result, had stabilised the financial system in many host countries. Integration into a sophisticated global marketplace - in terms of capital adequacy, capital allocation, risk management and credit allocation - and the value of new financial products were particularly positive. Against this background, the key question was the possible role of central banks in maximising the benefits of FSFDI.
In order to properly assess potential trade-offs and policy alternatives, FSFDI had to be seen in the broader context of globalisation. Foreign participation exposed EMEs to two underlying trends in the global financial system - the implementation of market-based practices in financial institutions and widely dispersed ownership. The question was whether the benefits resulting from these trends - improved capital allocation and corporate governance - were transmitted to the host country in full. Moreover, one had to be clear about the possible alternatives to foreign participation.

Higher external vulnerability was a natural by-product of globalisation. But recent crises had mainly been externally generated and of macroeconomic origin, rather than caused by individual banks. The biggest potential issue was a problem with the parent bank. The best policy was to prevent problems through monitoring of the parent bank, which was the responsibility of the group supervisor. Host countries had the responsibility for supervising subsidiaries. The fact that no problem with a major internationally active bank had emerged proved that this approach was right.

**Activities of foreign banks.** One issue was the provision of financing to specific sectors. It was argued that the tendency of foreign institutions to focus on specific profitable markets - consumer finance was the main example - justified measures to limit the activities of foreign-owned financial institutions. Another view was that foreign institutions tended to be deeply involved in the host country financial system and were willing to broaden business if the framework was there. It was unrealistic to expect that domestic policies would eventually be able to restrict globally active institutions. From this perspective, a successful policy would aim at creating the preconditions for financial institutions to develop new markets.

What could host countries do? Several comments emphasised the need to improve legal and accounting frameworks. Related to this were information collection and protection. An associated element was developing common capital markets. Developing the infrastructure for well-functioning financial markets was important for stimulating both foreign and domestic investment. It was also instrumental in managing exposures to foreign shocks that globalisation introduces.

The possible effect of the rapid expansion of foreign currency lending to both households and businesses on the resilience of host financial sectors was a theme in CEE. What was the respective role played by the high level of foreign ownership in the banking sector and the prospect of joining the euro area? Strong credit growth was an issue, especially if the strategic objectives of foreign banks were not always in line with the need for macroeconomic stabilisation in the host country. In addition, foreign ownership had increased concentration in particular in smaller economies. The experience in the Czech Republic was quite different. Borrowing in foreign exchange was decreasing. There was a need to look more closely at the evolution of non-performing loans in local and foreign currency. The key issue was the exposure of unsophisticated borrowers to currency risk that had the potential to become manifested as credit risk for the lending institution.

Another issue was that the interests of the shareholders of the parent bank did not necessarily maximise the value of the individual subsidiary for the host country. Decisions taken at the group level might for instance give some subsidiaries more room and reduce it for others. Against this background, compliance with local regulations was not enough. The existence of proper incentives, especially effective market discipline, was important. Revising host country laws and regulations regarding the corporate governance of domestic banks to broaden the responsibilities of local bank boards, including the responsibility for protecting the interests of domestic stakeholders, was suggested as a possible policy response.

Differences in foreign regulation and accounting practices among home countries were seen to have affected host domestic markets. The more diverse regulations and supervisory criteria in home countries were, the larger the impact on the competitive environment and liquidity in host markets as subsidiaries had to comply with host and home country rules and regulations. Subsidiaries of foreign banks had to follow local and foreign regulations, but for business decisions the strictest rule prevailed. A host country with parent banks from different countries could end up being subject to different rules, eg different capital charges for the same operation. The result was an uneven playing field and a loss of liquidity in domestic markets. Possible policy action included speeding up international convergence efforts for regulations and standards, especially among G10 countries.

Several Asian countries faced the challenge of how to sequence the opening of domestic financial systems to foreign participation with other policy measures. The absence of a sequencing strategy could cause problems, especially when the framework for risk assessment, as well as for management and supervisory capacities, was underdeveloped in the host country. Public discussion of sequencing
strategies was also viewed as a means to signal to domestic banks the need to prepare for competition.

It was suggested that some countries might want to move to Basel II more quickly, given the incentives involved for better risk management. This would work in the direction of strengthening the domestic banking system in general - both in terms of operational efficiency through consolidation and in terms of supervision.

The relevance of the legal form of foreign operations. Several countries restricted foreign presence to the opening of branches, often in connection with limitations on business activities. This allowed control over the impact of foreign banks on the domestic financial system. Others argued that having subsidiaries as domestically chartered banks provided a better starting point for supervision than having branches. Mention was made of Hong Kong SAR, where a local charter was a means to achieve a preferred entry into the Chinese market.

The transformation of (systemically important) subsidiaries into branches was seen as a key issue going forward. In CEE, the adoption of the single EU passport had resulted in a speeding-up of the process of changing the legal form of operations. The establishment of new branches was less of a problem as the market was already occupied. Moreover, the centralisation of the decision-making process led to a system in which subsidiaries operated like branches. What if a foreign parent abandoned a branch?

Cooperation among authorities in charge of financial stability. Cooperation among supervisory authorities was a major theme in all regions. One key issue was to identify the information needs of those in charge of financial and macroeconomic stability. Information disseminated to markets and to regulators needed to be clearly distinguished.

Adequately informed supervisors and hence information sharing among the authorities in charge of financial supervision were the necessary precondition for FSFDI to be beneficial. The establishment of coordination mechanisms between host country and home country as well as linkages across regulatory agencies was one element. Several participants commented on the need not only to focus on individual institutions, but also to consider the system as a whole. It was important to agree on standards for information exchange. Otherwise it would be very difficult for the host country to rely on the home country. Others, however, pointed to potential difficulties in implementing such mechanisms, possibly on a global basis.

Ensuring adequate information also included the need for regulators to keep abreast of product innovation in order to understand the risks and challenges facing risk management. Several mechanisms were considered, including training by public sector entities such as the Financial Stability Institute. In particular, the ongoing dialogue with the private sector could be beneficial. It was also stated that the cost of supervision was of increasing importance to the decision-making of foreign investors.

The Basel Committee paper on elements of a statement of cooperation stressed the role of home countries. However, some comments suggested that these were not fully informed about the situation in host countries. There was a need for a general framework for cross-border information exchange, as there were clearly deficits in this area. Memoranda of understanding were not a necessary precondition for information exchange, but they were important in organising information flow.

Several participants noted a potential discrepancy between the home and host country view. Subsidiaries were of marginal importance from the parent’s perspective, but might well be systemically important for the host country. What would happen in the event of a crisis? Host country authorities recognised the need for consolidation, but had more confidence in a subsidiary structure that gave them the right to obtain information and exert oversight. But even in the case of subsidiaries, host country authorities had to rely on access to information by the home country. In this context, outsourcing at the parent level and the assessment of the resulting operational risk was cited as an example.

Supervisors tended to emphasise the strength of individual institutions, while central banks focused on systemic stability. It was therefore extremely important that central banks talked to each other. One important issue was to establish ex ante criteria for information exchange between home and host countries.

Loss of information for markets. The delisting of subsidiaries led to a loss of market prices and scrutiny by independent analysts. Possible policy requirements for responses included strengthening the rules
regarding the disclosure of timely and meaningful information. There was a need to carefully consider the cost and benefits of issuing equity and/or subordinated debt. Moreover, information flows from parent banks to markets and from home supervisors to host authorities had to be improved, including cooperation between host and home supervisors and central banks to deal with liquidity and insolvency crises and involving emerging market economies in discussions and studies of cross-border insolvencies.

Domestic ownership was also important in the light of a growing domestic institutional investor base. Local listing enhanced market transparency and created investment opportunities in domestic blue chips. The question here was how to combine responsibility vis-à-vis shareholders with the trend towards centralisation: for instance, what are the possible benefits and costs of ceilings on foreign ownership of shares?

Stock prices were a powerful tool to exert discipline on local operations. But the analyst community could do more as there was only very broad disclosure by geographical area. Most countries had to be careful not to interfere with others’ rights when reconsidering corporate governance. Some speakers expressed scepticism about the need to provide an additional corporate governance mechanism.

Box 1

Luncheon address by Governor Caruana in Mexico City

The first issue addressed by Governor Caruana was whether Basel II would affect international capital flows. Two main arguments spoke against abrupt changes. First, the pricing of loans by large international banks active in lending to emerging market economies already reflected economic risks and was not driven by regulatory capital requirements. In this sense, Basel II aligned supervisory practice with current industry practice. Second, Basel II included mechanisms that were intended to reduce the risk of capital flow volatility. The advanced approaches encouraged through-the-cycle estimates and stress test scenarios; more importantly, Basel II established incentive mechanisms to constantly improve risk management systems. Governor Caruana emphasised the need to include the positive effects of Basel II to improve risk management and thereby foster financial stability in the public debate.

The second theme was the increasing need for cooperation between home and host country supervisors. This was the natural result of the internationalisation and integration of financial activity. In this regard, Basel II would play a key role as catalyst for cooperation among supervisors. Communication and reliance on information provided by other supervisory authorities were necessary to avoid redundancies and inefficiencies in the cross-border implementation of Basel II. The home country was in the best position to evaluate the “advanced” approach across a group. The host country supervisors were best suited to deal with local provisions - an allocation of responsibilities consistent with their legal role.

How should cooperation be organised? There was no such thing as a single approach for cross-border cooperation. The August 2003 high-level principles for the cross-border implementation of the new capital framework provided a good starting point. It was clear that approaches to cooperation should be pragmatically implemented and, in any case, none of these arrangements would affect the capacity of host country authorities to conduct effective supervision. Home country supervisors should play the leading role in organising these arrangements and communicating them to the relevant supervisors and the affected banking groups. This implied greater mutual reliance among supervisors. Host country supervisors should think carefully about what they needed when placing more emphasis on agreements, such as what their communication strategies with other supervisors should be.

Emergency liquidity assistance. Another issue of interest to central banks was emergency liquidity assistance (ELA) to financial firms with operations in multiple countries. In this context, non-discriminatory treatment by host country authorities regarding liquidity support to foreign banks was identified as a key principle by some participants. In addition, there was discussion of the information needs of home and host country authorities relating to the activities of foreign subsidiaries in the host country and the condition of the parent financial institution. Meeting participants also mentioned the need to exchange such information, the potential value of contingency planning for liquidity crises, and more direct forms of cooperation in times of contingency (swap arrangements).
Concluding remarks

The discussions in the three workshops underlined the usefulness of bringing together home and host country central banks to discuss the topic of FSFDI. The main common theme was the organisation of communication and information flows between home and host country authorities in charge of financial stability. The issues raised were much broader than information exchange between financial supervisors, including aspects such as the availability of market information and the effectiveness of market discipline, corporate governance, coordination in crisis situations and emergency liquidity assistance. Further consideration of these issues involving the public and private sectors as well as academia appears warranted in order to maximise the benefits of the global integration of the financial sectors of emerging market economies.
Agenda
Foreign direct investment in the financial sector
CGFS workshop

Day 1 (afternoon)

Session I
Introductory remarks by Chairman Ferguson
Themes explored in the report of the Working Group
- Overview presentation by Ms Christine Cumming, First Vice President, Federal Reserve Bank of New York
- Spillover effects: reflections on the consequences of foreign presence for the performance of financial systems in emerging markets
- Risk management challenges of FDI for: (1) parent banking firms; (2) oversight by the home country; and (3) oversight by the host country
- Tour de table - central banks from the region
- Open discussion

Day 2 (morning)

Session II
Private sector perspectives (15 minutes per presentation)
- Spillover effects: foreign presence and the management of domestic banks in emerging markets
- Risk management: issues involved in conducting operations in an emerging market economy
- Outlook: the future of foreign banks and other financial firms in the region
- Open discussion

Session III
Policy issues concerning financial sector FDI in Latin America: a global financial system perspective
Lessons learned and policy choices faced by host country authorities
Reflections on the policy discussion in the light of the report of the Working Group
Open discussion
Summing-up by the Chair
## Participants

**Bank of Korea, 1-2 June 2004**

<table>
<thead>
<tr>
<th>Country</th>
<th>Participant</th>
</tr>
</thead>
</table>
| Chair       | Mr Roger W Ferguson Jr  
Vice Chairman  
Board of Governors  
of the Federal Reserve System |
| Australia   | Mr Philip Lowe  
Assistant Governor  
Financial System  
Reserve Bank of Australia |
| Brazil      | Mr Afonso Bevilaqua  
Deputy Governor for Economic Policy  
Central Bank of Brazil |
| China       | Mr Mu Huaipeeng  
Director General  
Research Bureau  
People’s Bank of China |
| Hong Kong SAR | Mr Bill Ryback  
Deputy Chief Executive  
Hong Kong Monetary Authority |
| India       | Mr C R Muralidharan  
Chief General Manager In Charge  
Department of Banking Operations and  
Development  
Reserve Bank of India |
| Indonesia   | Mr Basir Ardiansyah  
Chief of Division  
Bank Indonesia |
| Japan       | Mr Ryuji Yasuda  
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J-Will Partners Co, Ltd  
Mr Eiji Hirano  
Executive Director  
Bank of Japan  
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Representative Office for Asia and the Pacific
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Head of Secretariat, CGFS
Mr Dietrich Domanski
Senior Economist, CGFS
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</table>
| Chair        | Mr Roger W Ferguson Jr  
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| Argentina    | Mr Pedro Lacoste  
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               Central Bank of Argentina |
|              | Mr Norberto J Pagani  
               Head International Relations  
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               Adviser - International  
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               Central Bank of Chile |
| Colombia     | Mr Mauricio Avella  
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                  European Central Bank |
| France       | Mr Stéphane Latouche  
               Financial Counsellor  
               French Embassy |
| Mexico       | Mr Luis Peña  
               Chief Executive Officer  
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               Ms Ursula Wilhelm  
               Director  
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               Mr Juan Pablo Graf  
               Bank of Mexico  
               Mr David Margolin  
               General Director, Central Bank Operations  
               Bank of Mexico  
               Mr Pascual O’Dogherty  
               Director, Financial System Analysis  
               Bank of Mexico |
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Senior Economist, Emerging Market Issues Unit
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Bank Austria Creditanstalt |
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| European Union  | Mr Georges Pineau  
Deputy Director General, International and European Relations  
European Central Bank |
| France          | Mr Michel Cardona  
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| Germany         | Mr Wolfgang Fritsch  
Deputy Head of International Relations Department  
Deutsche Bundesbank |
| Italy           | Mr Giorgio Gobbi  
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Credit Intermediaries Office, Research Department  
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Foreign direct investment in the financial sectors of emerging economies
<table>
<thead>
<tr>
<th>Country</th>
<th>Name</th>
<th>Position/Department</th>
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<tbody>
<tr>
<td>Latvia</td>
<td>Ms Zoja Medvedevskiha</td>
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<td>Mexico</td>
<td>Mr Pascual O’Dogherty</td>
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<td>Netherlands</td>
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<td>National Bank of Poland</td>
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<td>Mr Jerzy Pruski</td>
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<td>Mr Jacek Osinski</td>
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<td>Romania</td>
<td>Mr Eugen Radulescu</td>
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<td>Sweden</td>
<td>Mr Mattias Persson</td>
<td>Head of Macro Prudential Analysis</td>
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<td>Sveriges Riskbank</td>
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<td>Turkey</td>
<td>Ms Çiğdem Koğar</td>
<td>Manager, Banking and Finance Institutions</td>
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<td>Central Bank of the Republic of Turkey</td>
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<td>United States</td>
<td>Ms Christine Cumming</td>
<td>First Vice President</td>
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<td>Chairman, Financial Stability Institute</td>
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