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Workshops on EME banking systems and regional financial integration

Summary of follow-up workshops organised by the Committee on the Global Financial System

The workshops were chaired by Chia Der Jiun, Monetary Authority of Singapore and Fernando Restoy, Bank of Spain

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Summary: follow-up workshops on EME banking systems and regional financial integration

Monetary Authority of Singapore (MAS), Singapore, 4 August 2014 and
Bank of Spain, Madrid, 24 October 2014[1]

1. Background

The two workshops, organised jointly with SEACEN and CEMLA, at the Monetary Authority of Singapore and the Bank of Spain, respectively, brought together public and private sector participants to discuss financial integration trends, with a particular focus on regional emerging market banking systems. The aim was to disseminate and discuss the key messages in the March 2014 CGFS report on "EME banking systems and regional financial integration",[2] and to gain additional information on more recent developments in the Asia-Pacific and Latin American regions as well as on any related issues not covered in the report.

Both workshops followed identical formats, consisting of three sessions each. In the first, participants shared their views on whether and how regional integration would continue, identifying important drivers as well as the main constraints. The second session focused on the business models of regional banks, on how these compare to those of their competitors, and on the market implications of financial integration. The third session considered key messages and policy implications.

Discussions that occurred in the first two sessions are summarised immediately below. These are then followed by the key messages and policy implications.

2. Summary of discussion

2.1 Trends and drivers

One of the main takeaways from the two workshops was that private sector participants in both regions expect cross-border activity to continue to expand, but at a slower rate than anticipated in the recent CGFS report. Regional financial integration among emerging market economies has generally been increasing, with the process of expansion having sped up since the global financial crisis, albeit with

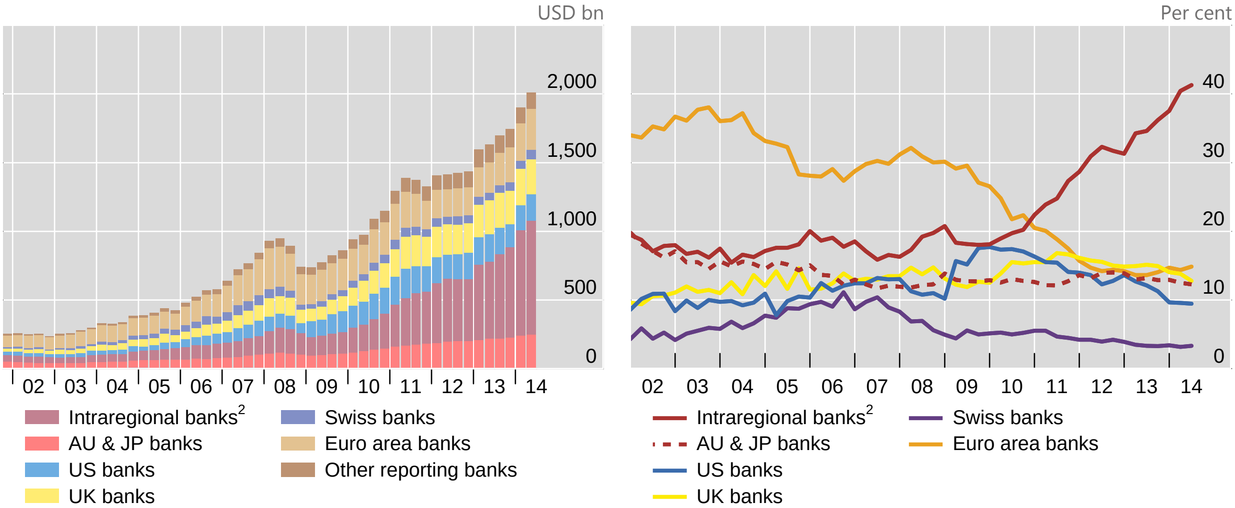
1 The workshops were chaired by Chia Der Jiun (Monetary Authority of Singapore) and Fernando Restoy (Bank of Spain), respectively.

2 See CGFS, "EME banking systems and regional financial integration", *CGFS Papers*, no 51, March 2014, http://www.bis.org/publ/cgfs51.htm; see the Appendix for an executive summary.

considerable differences across regions and jurisdictions (Graphs 1A and 1B).[3] Trade flows and related corporate banking activities were mentioned as the most important drivers of regional integration, reflecting different variants of a "follow-your-client" strategy. In Asia-Pacific, cross-border banking in the frontier markets, in particular, has tended to be rather supply chain-oriented, particularly towards manufacturing goods. As supply chains evolve more quickly than in the past, geographically and otherwise, one approach taken by regional banks in Asia-Pacific was to target foreign firms along the supply chain of their current customers, thus making interactions between these firms easier. An example mentioned in this context was Pakistan, where Chinese banks were expanding in order to support Chinese multinational corporations. Trade finance and other forms of transaction banking were thus considered more important for financial integration in Asia-Pacific than, for example, funding for mergers and acquisitions.

Bank credit to emerging Asia-Pacific — Graph 1A

International claims on the region[1] — Share in international claims on the region



[1] Sum of all cross-border claims and locally extended claims in foreign currency. [2] Intraregional share is the sum of international claims on the emerging Asia-Pacific region of banks headquartered in Chinese Taipei, Hong Kong SAR, India, Singapore and the offices of banks located in the region that have a parent institution from a non-BIS reporting country (assuming these are headquartered in Asia).

Source: BIS consolidated banking statistics (immediate borrower basis).

In the Latin American region, regionally active banks tend to follow a somewhat different variant of the "follow-your-client" strategy, which is more explicitly targeted at supporting the international activities of large corporates from banks'

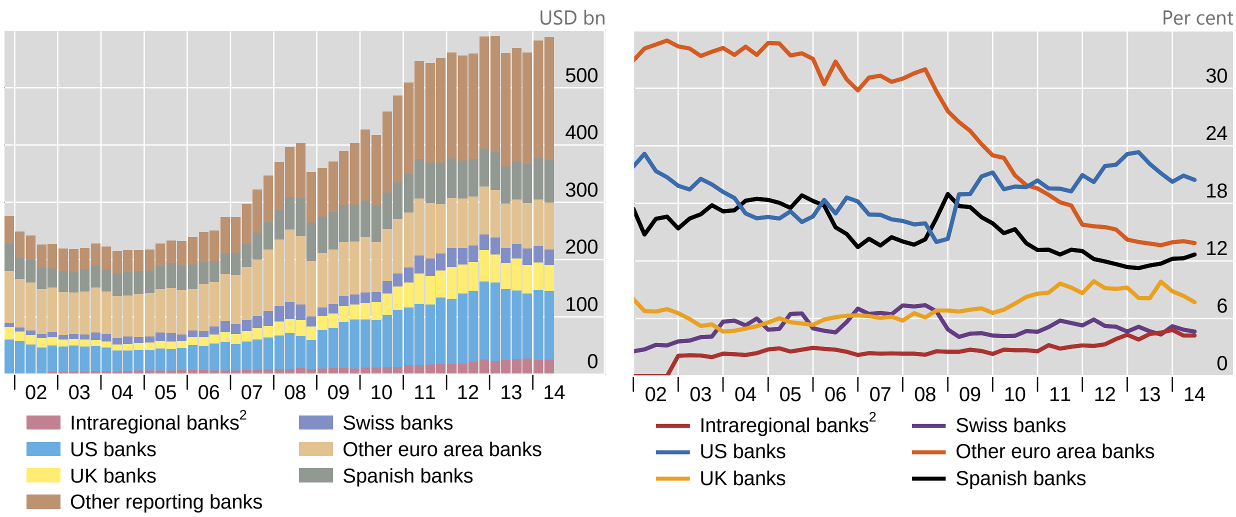
[3] BIS consolidated banking statistics cover reporting banks' worldwide consolidated claims, which include: cross-border claims from banks' home jurisdictions and local claims by their subsidiaries and branches within a particular country (in both foreign and local currencies). International claims are defined as cross-border claims and local claims in foreign currency and, hence, do not include local claims in local currency. In the graphs, the latter type of claim is excluded in order to compare the share of claims of BIS-reporting banks to those of non-reporting banks operating in reporting countries, for which data on local claims in local currency are not available. This is particularly relevant for Asia-Pacific because of the growing activity of Chinese banks operating from Hong Kong SAR. A substantial share of foreign bank claims in Latin America and the Caribbean, in contrast, comprises their subsidiaries' local claims in local currencies. Therefore, these estimated shares should be treated as a lower bound, providing only partial insight into EME financial integration trends. For data including local claims in local currency, see Annex 2 of CGFS (2014).

home jurisdictions. Therefore, much of intraregional bank expansion, both in the Southern Cone as well as in Central American countries, has tended to reflect corporate banking activities. Against this background, trade was cited as an important driver in the Latin American region as well. However, with only about a quarter of trade flows being intraregional, compared to about half in Asia, the pace of accompanying financial integration among Latin American economies has been slower. The integration process has also been more concentrated, with Brazilian and Colombian banks being among the most regionally active institutions, given the rising regional presence of large corporates from both countries.

Among the other important drivers mentioned at both workshops was macroeconomic and institutional convergence, with a broad trend towards better institutions, more predictable policies and independent central banking facilitating banks' cross-border expansion. In Latin America, in particular, workshop participants highlighted that South-South macroeconomic integration continued to be on the rise, as illustrated by FDI flow patterns, and that this would tend to support financial integration. In addition, participants at both workshops mentioned the (temporary, in some cases) retrenchment of advanced economy banks from non-core EME locations and business lines as a key catalyst for the most recent round of intraregional bank expansion. Saturation of domestic markets and various "soft" factors (such as geographical and cultural proximity) were also highlighted as additional determinants of regional expansion.

Bank credit to Latin America and the Caribbean — Graph 1B

International claims on the region[1] | Share in international claims on the region



[1] Sum of all cross-border claims and locally extended claims in foreign currency. [2] Intraregional share is the sum of international claims on the emerging Latin America and Caribbean region of regional banks (Brazil, Chile and Mexico) and Caribbean offshore banks (Panama) divided by total international claims on the emerging Latin America and Caribbean region.

Source: BIS consolidated banking statistics (immediate borrower basis).

Constraints on further regionalisation. Private sector participants at both workshops stressed that achieving meaningful growth in foreign markets can be very challenging. One of the reasons why participants thought regional integration would likely be slower, and more selective on a country-by-country basis, than anticipated in the CGFS report was the risk of uneven regulatory implementation and associated unlevel playing fields across countries. For example, many market practitioners voiced concern that the combination of Basel III with national subsidiarisation and ring-fencing requirements could constrain cross-border expansion by impeding efficient allocation of capital and liquidity among banks' foreign affiliates. At the same time, views differed across regions on how pronounced such effects are likely to be. At the Madrid workshop, for example, some participants felt that regulatory frameworks in Latin America and the Caribbean were more homogenous than those in other regions.

Views also differed on the cost-benefit trade-offs of subsidiarisation (see also Section 2.2 below). While participants at the Madrid workshop highlighted the financial stability benefits that subsidiarisation has brought to Latin America (recalling also the experiences of Spanish banks), the participants of the Singapore workshop were more focused on the associated costs and inefficiencies. They argued, for example, that subsidiarisation is capital-intensive and that ring-fencing requirements could end up trapping liquidity in specific markets or jurisdictions. In response to such concerns, several supervisors from the Asia-Pacific region noted that their respective jurisdictions had been reviewing local regulations with a view to making adjustments (eg by lifting limits on the number of foreign bank branches), while retaining some regulatory flexibility depending on a specific bank's business model and long-term intentions. This highlighted the importance of finding the right balance between prudential objectives and banks' interests in an efficient allocation of funds.

Another difference across workshops was that participants from the Latin American region seemed more focused on headwinds from local competition when setting up foreign subsidiaries. Outside the smaller frontier markets, growing foreign businesses organically, for example by setting up retail banking operations and attracting deposits, was described as extremely difficult. Therefore, the typical mode of regional expansion was to first rely on corporate and, in some cases, investment banking activities, and to otherwise look for acquisition opportunities to expand through M&A at a later stage. This was the model that the Colombian banks had followed during their recent expansion in Central America.

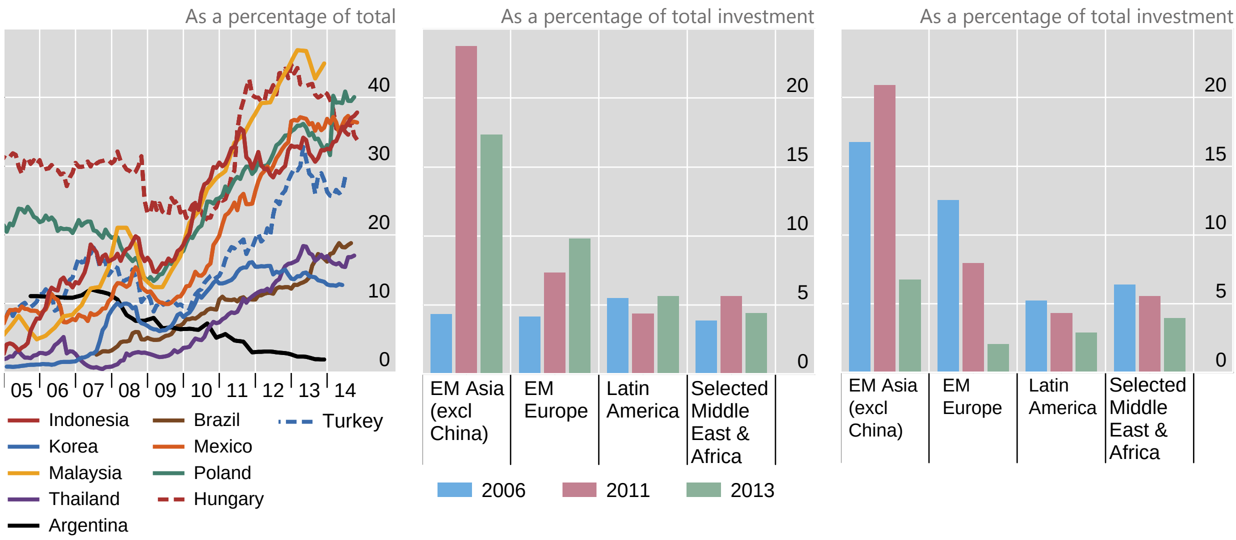
Finally, workshop participants listed a number of more structural constraints. These include the differences between regional economies (including tax regimes) combined with constraints on the ability of banks to attract or develop staff with the necessary country-specific expertise to keep pace with foreign expansion. The same applies to existing risk management and governance frameworks. Similarly, as highlighted in the CGFS report, underdevelopment of local capital markets, currency volatility and the associated lack of deep hedging markets were cited as key challenges to the regional financial integration process.

Securities markets. One finding in the CGFS report is that the degree of intraregional investment in debt and equity securities varies greatly by region. While residents of the Asia-Pacific region have noticeably increased their intraregional investment in debt and equity securities over recent years, regional diversification by Latin American residents has not kept pace (Graph 2). These trends were broadly confirmed by workshop participants, who also pointed to initiatives such as Mercado Integrado Latinoamericano (MILA), which seeks to integrate stock markets in Chile, Colombia and Peru, as illustrating the incipient integration of capital markets in the region. As such, they may also have supported the recent expansion of Brazilian investment banks into Chile, Colombia, Mexico and Peru.

Despite these positive signs, participants at both workshops emphasised the pronounced home bias of regional investors and the special role of the US dollar in EME currency and debt management as some of the main obstacles to greater integration in regional securities markets. For one, currency risk, combined with shallow hedging markets, limits the willingness of regional investors to participate in local currency bond markets. To the extent that they want to diversify, US dollar bonds (and instruments denominated in other major currencies) are the preferred option. The shorter maturity of local currency bonds was also cited as a factor limiting institutional investor appetite for these instruments. Investors, therefore, tend to be tempted into the major benchmark indices and international bonds issued by larger borrowers, without any particular geographical orientation. The differences between regional markets and the lack of country-specific expertise (see above) add to this behaviour.

Selected indicators of regional debt and equity investments — Graph 2

Selected EMEs: foreign ownership of local government securities | Total debt securities investment from EMEs to other countries in own region[1] | Total equity securities investment from EMEs to other countries in own region[1]



[1] Excluding investments to offshore centres within own region.

Sources: IMF, *Coordinated Portfolio Investment Survey*; CEIC; EMED; national authorities.

On the borrower side, US dollar debt issuance has been particularly attractive recently, due to the funding advantage over domestic markets. The share of US dollar borrowing has been particularly high in Latin America, where an additional incentive comes from matching the dollar receipts of major commodity exporters in the region. Much of Latin American US dollar debt is booked offshore in the Cayman Islands and other Caribbean jurisdictions. US dollar debt issuance has also been increasingly important for borrowers from smaller frontier markets in Asia; these would often issue via regional financial centres such as Hong Kong SAR and Singapore.

2.2 Business models and market implications

Workshop participants agreed that bank business models (ie foreign subsidiaries versus branches, local funding versus international funding, and diversification across lines of business or across countries) can have strong implications for financial integration.

The CGFS report highlights that regional EME banks appear to exhibit higher capital buffers and a stronger focus on local deposit funding than their advanced economy peers (with the possible exception of Spanish banks in Latin America, which are run as independent units, with a strong base of local retail deposits). This is consistent with the input from representatives of EME banks, who noted that their institutions expanded primarily via foreign subsidiaries, implying a business model based on the autonomy of each affiliate's capital and liquidity management. On this basis, banks' expansion often takes place via acquisitions of existing local entities (M&A), which grants them access to local sources of funding, including retail deposits. The subsidiary model has been particularly prevalent among Latin-American banks, which tend to operate from a strong retail base. In contrast, in the Asia-Pacific region, where both the business lines of regional EME banks and local regulatory requirements tend to be more diverse, modes of operation appear to vary more as well, with both the branch-based and subsidiary models being pursued, where feasible.

Funding models. According to the private sector participants, the global financial crisis and resulting regulatory response have caused banks to rethink their funding models and return-on-equity (ROE) targets. One aspect of this development is a renewed focus on more traditional approaches to funding with an emphasis on a stable local deposit base (see above). The competitive nature of deposit markets in many countries, combined with regulatory constraints and ROE considerations, in turn, means that regional banks have become much more selective in terms of their target markets.

Participants also discussed their reliance on non-deposit funding, including debt issuance. Workshop participants from the Latin American region, where banks' international debt issuance has been particularly strong since the crisis, pointed out that debt funding was driven by both structural and cyclical factors. The cost advantage over domestic markets and robust demand by foreign investors were cited as some of the most important factors. Market access, in turn, was apparently aided by the subsidiary mode of expansion used in the region, which helped shield banks from the market risk premiums imposed on their head offices during crisis periods. For example, despite the credit rating downgrades of Spanish banking groups, their local affiliates in the region broadly maintained their credit quality and continued to issue debt throughout the euro area crisis. On the demand side, investor interest seemingly remained strongest for US dollar debt, given that key institutional investors in Latin American debt are either headquartered in the United States or cater to US clients.

Market implications. Overall, participants noted that regional integration had generated tangible benefits that should support further steps towards integration by both the private and public sectors, including in those countries currently lagging behind. Despite possible concerns over capital and liquidity allocation across countries, such as in the Asia-Pacific region, there was a sense that specialised financial services are more widely accessible and risks tend to be better diversified as a result of regional integration trends. Foreign bank expertise in areas such as debt placement, in turn, was seen as supporting efforts at market deepening. Cross-border banking was also noted as having generally spurred domestic competition, allowing banks to achieve greater scale. Outside the frontier economies, however, technology at local banks (with the possible exception of retail payments automation) was seen as largely up to date, limiting the potential for further technological spillovers.

A challenge for the industry is how to strengthen corporate structures to meet regulatory requirements and how to aggregate risk management-related data at the group level. Private sector participants suggested that, even if local entities are fully subsidiarised, more attention may have to be given to risk management control at the group level rather than for each jurisdiction. They also expressed concern about the way regulation is being implemented across jurisdictions, highlighting the role that unlevel playing fields (eg those arising from regulations that favour domestic banks) could play in hindering further integration. As an alternative to ring-fencing, some suggested improved risk management and regulatory cooperation as well as closer dialogue between banks and regulators.

3. Key takeaways

At both workshops, discussions (excluding the private sector participants) of key takeaways and policy implications focused primarily on the way forward for sustainable and high-quality regional financial integration. The key messages relevant for policy were as follows:

- **Speed and scope of integration.** Public sector participants at both workshops felt that the discussions had generally confirmed the trends and related challenges highlighted in the original CGFS report. However, they also agreed that the speed of further regionalisation may be slower than previously anticipated. In addition, globalising supply chains and differences between countries within regions may mean that regionalisation will be increasingly overlaid with a more general trend towards internationalisation.

- **Risk management guidance.** While more gradual integration will tend to provide policymakers and market participants additional time to adjust, both supervisors and banks need to prepare to address the resulting challenges, especially in frontier markets. In particular, risk management guidance should be high on the list of priorities, including monitoring balance sheet capacity and foreign currency funding. Risk management frameworks need to account for international shocks and linkages between banking systems.

- **Market development.** Policymakers in the Asia-Pacific region continue to focus on developing local financial infrastructure and deeper markets. In line with the CGFS report, measures to deepen hedging markets were suggested as a major step towards further financial market integration. In addition, it was noted that a well developed pension system can serve as a key catalyst for market development (as highlighted by the Australian example) by channelling long-term funds to both banks and non-financial corporates. In the case of frontier markets, there could also be scope to focus on joint capital markets instead of trying to build fully developed markets in each jurisdiction. These views were largely shared by policymakers from the Latin American region. One difference, however, was that capital market integration had apparently been a slower process in Latin America, with Chilean pension funds cited as one of the few examples of major institutional investors venturing outside their own jurisdiction in a meaningful way. Still, initiatives such as Mercado Integrado Latinoamericano (MILA) were cited as examples of how market integration could be accelerated within the region.

- **Regulatory cooperation.** Much of the remaining discussion among policymakers concerned regulatory and supervisory cooperation. There was a sense that, overall, the emerging framework for multilateral cooperation appeared to be working, even though the modalities continue to differ across jurisdictions. Among the constraints are asymmetries in regulatory powers between country authorities, which can drive a wedge between the ability and willingness to cooperate. In terms of channels of cooperation, supervisory colleges remain the instrument of choice for agreeing suitable metrics, sharing information and discussing policy options. However, participants also highlighted that the bigger, global supervisory colleges often lack sufficient focus on regional issues and that certain types of sensitive information are difficult to share in a college context. As a result, deepened bilateral relations among supervisors as well as memoranda of understanding (MoUs) were seen as important complements of the college-based approach to cooperation.
- **Dialogue with banks.** One way to support the trend towards regional integration is for regulators to try to balance their prudential objectives with efficient allocation of funds. Dialogue between banks and their regulators is an important tool in this context. Banks have already noted a significant increase in time spent communicating with regulators. Such dialogue can also help to demonstrate a bank’s commitment to a country, and help regulators familiarise themselves with the intentions of financial institutions within their respective jurisdictions.

Appendix: Executive summary of the CGFS report

Regional emerging market economy (EME) financial integration is on the rise. There are signs that banking groups headquartered in EMEs (EME banks) have stepped up their expansion activity, which is expected to raise their importance in regional financial systems. While this has the potential to affect the global financial system in a variety of ways, the still small overall footprint of these banking groups suggests that current trends are unlikely to have significantly changed the risk profile of EME banking systems at this stage. Yet, broader effects are possible over time and may warrant policy responses in a number of areas. Specific findings include:

Progressive growth in international claims on EMEs. Various indicators suggest that EME banking sector internationalisation is increasing. For example, aggregate cross-border claims (which include loans, deposits, debt securities and other financial instruments) on economies in the three major EME regions have increased almost threefold in the past decade. Although cross-border claims dipped sharply in 2008, they have since surpassed pre-crisis levels.

Growing international role of EME banks in the post-crisis period, with a strong regional orientation. The international expansion of EME banks has gained momentum since the 2008–09 financial crisis. This is evident in all EME regions, but has gained particular traction in Southeast Asia, Central America, and the Commonwealth of Independent States. EME bank participation in syndicated lending markets has also grown in recent years, offsetting in part retrenchment by euro area institutions. Expansion strategies demonstrate a strong regional orientation, with cross-border merger and acquisition activity among EME banks, for example, predominantly taking place within the same region.

Heterogeneity in the scale and mode of banks' cross-border expansion. There is considerable heterogeneity at the institutional and country level regarding the degree of EME bank international activity, and strategies for market penetration in other EMEs. In aggregate, EME bank foreign presence remains small relative to parent bank balance sheets and host country financial systems. Yet, there are notable exceptions, particularly in Southeast Asia, where EME banks facing more saturated banking markets have dedicated larger shares of their balance sheets to overseas lending. Expansion strategies also vary, with some banks pursuing largely organic expansions and others preferring strategic acquisitions. To some extent, this may be driven by underlying business models, with retail banking-focused operations favouring subsidiaries, and more centrally funded business lines tending to favour branches. In some countries, regulatory developments have also been a factor driving foreign banks to establish subsidiaries.

Drivers of current bank expansion are similar to past experience, but within a more competitive environment. Many of the drivers of current bank expansion in EME regions, such as reduced opportunities at home and pursuit of domestic clients, are similar to the drivers of past expansions into EMEs.

In the past, increased foreign bank participation benefited from extensive financial sector liberalisation, often in the wake of EME financial crises. Today, the conditions in many EME banking systems have changed significantly, with tighter regulatory environments and more competitive domestic banking sectors. On this basis, EME banks may be better positioned to capture significant market share in smaller frontier economies, where divestments or more limited activities by other financial institutions create opportunities for new players.

Relatively traditional, but evolving, business models. While the business models of regionally expanding EME banks differ by region, ownership structure, and size of foreign operations, key metrics suggest a greater focus on retail banking and deposit funding activities than many of their advanced economy peers. Higher capitalisation ratios of EME banks, in turn, suggest scope for further cross-border expansion, implying that internationalisation trends may continue to be fairly sizeable at least for individual countries.

At the same time, the evolution of balance sheet metrics for EME bank foreign affiliates points to rising convergence with longer-established advanced economy peers. This is particularly true for larger, more systemically important EME bank affiliates, which increasingly resemble their similar-sized, more regionally focused advanced economy peers – likely due to recent acquisitions as well as post-crisis adjustments to business and funding models. These developments suggest that banks' risk profiles are likely to further converge with time, as foreign affiliates of EME banks become increasingly active. Indeed, EME foreign affiliates have engaged in relatively aggressive new lending in EME markets since 2009. And, while much of this new activity is backed by deposit funding, there appear to be pockets of relatively greater reliance on interbank and market financing.

Costs and benefits. Many of the trade-offs currently faced by EMEs resemble, although in a new guise, the earlier experience of financial integration of EMEs with advanced economies. Potential benefits, such as allocative efficiency, better availability of specialised financial services (eg trade and project finance), market deepening and regional risk-sharing, will have to be traded off against potential costs. The flip side of diversification benefits, for example, is greater potential for spillovers at the institutional and system levels, particularly for EMEs where foreign bank operations account for a relatively large share of host system assets. This, in turn, raises new challenges in terms of the complexity and management of regional banks' operations, and can strain existing market and supervisory infrastructures.

Policy implications. For policymakers, these findings imply scope for action in two broad areas: (i) improving regulatory environments and market infrastructures, and (ii) crisis prevention and resolution. In the former area, constraints on the ability of banks to better hedge their balance sheet risks can be eased by stepping up efforts to improve local market infrastructure (eg further developing local markets for bonds and related hedging instruments), while formulating explicit supervisory guidance to help improve banks' risk management and stress testing frameworks (eg incorporating regional shocks into stress test scenarios). In addition, supervisors may need to enhance their efforts to monitor and address balance sheet mismatches, such as those arising from foreign currency funding, while balancing the costs and benefits of any associated regulatory measures (eg subsidiarisation or constraints on certain types of funding).

In the area of crisis prevention and resolution, in turn, steps can be taken to better address spillovers as well as strengthen existing safety nets. In both cases, regional efforts have a particular role to play, building on established frameworks, such as supervisory colleges or regional forums. This can be particularly challenging in countries where supervisors and other authorities are relatively tightly resourced or have limited experience with cross-border issues. As regards safety nets, despite their overall relatively small size, regional financial arrangements, when sufficiently developed, offer a number of possible advantages in terms of the provision of confidence-enhancing effects and in helping to address idiosyncratic and regional shocks – provided that effective conditionality arrangements can be put in place.