Guillermo Ortiz: The participation of international banks in emerging economies

Keynote address by Mr Guillermo Ortiz, Governor of the Bank of Mexico, at the 14th International Conference of Banking Supervisors, Mérida, Mexico, 5 October 2006.

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I would like to thank the Comisión Nacional Bancaria y de Valores and the Basel Committee on Banking Supervision for their invitation to address this important group of bank supervisors from all over the world.

I would like to focus my remarks on some of the challenges that supervisors face in the evolving financial landscape. In particular, I would like to follow two lines of thought:

- First, the impacts on emerging economies of the globalization of financial markets and institutions, and
- Second, the increasing relation between commerce and banking.

As we all know, banks are special. They constitute the nervous system of the economy. They facilitate the channeling of resources from depositors to investors and provide households and companies with access to the payment system.

Given the important role that banks play in an economy, they enjoy the protection of the so-called safety net, which usually includes a deposit insurance scheme and access to liquidity from a central bank. And because banks operate in this special environment, financial authorities pay particular attention to their regulation and supervision.

Authorities have a natural tendency to over regulate, since as we all know, regulation is not provided through market processes. However, regulatory regimes play an important role in determining the efficiency and stability of financial systems, which, in turn, influence overall economic performance.

Hence, it is important to achieve just the right dose of regulation - not too much, not too little, which is exceedingly difficult to do. To facilitate this process, financial authorities must have a clear and limited set of objectives and roles.

There are three commonly identified objectives for the regulators and supervisors of financial systems:

- Sound financial institutions
- A stable financial system
- And consumer protection.

Usually bank supervisors concentrate on the first of these objectives, while central banks look after the second, and consumer protection agencies, the third. However, the three of them are closely related. To succeed in any of them, it is important to consider the impact of any policy measure on the other two.

I. Characteristics of the financial landscape

The world financial landscape has evolved rapidly in the last few decades. The globalization of financial markets and institutions implies that the reallocation of capital and the transmission of price shocks across markets and geographic regions proceed much faster than before.

Financial institutions are increasingly expanding overseas. There are several factors that explain this phenomenon.

- The nature of cross-border banking evolved after the foreign-exchange crises and sovereign defaults of the 1980s. Banks are increasingly trying to mitigate transfer and exchange-rate risks by funding their activities in the same location where there are doing business.
- Technological advances in communications and computing capacity facilitate the fast processing of information to price risks in different sectors and regions.

- There is an emphasis on tapping the profitable household sector, which requires a local consumer retail base and thus a "bricks and mortar" presence. It is in emerging markets where the growth potential of consumer and mortgage credit lies.
- Economies of scale and the replication of successful home-grown business lines and products abroad present enormous advantages.
- Banks need to gain size to prevent unfriendly takeovers.

Whatever the reason, the presence of foreign banks has been increasing especially in developing countries where on average they now account for 40% of total bank assets.

Foreign penetration in banking systems varies largely among countries. Foreign banks own more than 80% of banking assets in Mexico, Poland, Hungary, Bulgaria, and Estonia, but only 20% in Brazil.

More recently, there has been penetration by banks from developing countries in banking systems from other developing countries. According to the World Bank, 27% of developing countries' foreign banks are owned by banks established in other developing countries.

II. Challenges for emerging economies' supervisors

There seems to be ample agreement about the benefits of globalization as well as the challenges that this new landscape poses to financial authorities.

Among the benefits derived from the entry of foreign banks in emerging economies are improvements in efficiency, and the introduction of new products and technologies, as well as a reduction in connected lending practices.

In this presentation, I would like to highlight some of the challenges faced by regulators, supervisors, and central banks from emerging economies. In particular, I will refer briefly to the impact of a foreign bank presence with regard to:

i) the soundness of local banks

ii) local market discipline

iii) the impact of foreign regulations on domestic markets

iv) the resolution of troubled global banks, and

v) competition in domestic financial markets.

i) The soundness of local banks

The overseas expansion of international banks can take place through the establishment of branches and subsidiaries. I would like to concentrate on the latter since it is the prevailing legal form used by large banks, and it is also the only possibility for a foreign financial institution to establish a presence in the Mexican market.

As we all know, subsidiaries are locally incorporated and legally independent from their parents. Nevertheless, international banks increasingly manage their subsidiaries as if they were branches. They allocate their capital and business lines across the whole group to those areas that offer the most attractive risk/return profile. However, they keep their legal responsibilities limited to the capital invested in each individual unit.

The way in which international banks are managed could lead to decisions that are good for the international bank but not necessarily positive for the subsidiary. We can provide some examples to illustrate this.

- There is a growing tendency to book some transactions where funding and regulatory costs are lower. Although this makes sense from the international banks' perspective, it shifts revenues away from the local banks where the business is originated with, among others, obvious fiscal implications.
- International banks usually establish individual limits to credit exposure in each foreign country, according to the sensitivity of the overall portfolio. Thus, subsidiaries sometimes have to reduce their local exposures, even though these exposures are also financed locally.

- International banks are also increasingly inclined to adopt matrix reporting arrangements by which local treasurers, comptrollers, and risk managers report directly to their parent bank's counterparts rather than to the local CEOs. Bank directors and managers are usually long-career employees of the parent bank. In some cases local CEOs are some sort of ambassadors with few operational responsibilities.

This concentration of decision-making powers and rewards at the parent level should be a matter of concern for financial authorities since the parent bank does not have parallel legal responsibilities over their subsidiaries.

The Basel Committee has revised its guidelines on corporate governance in banking organizations. One key area of progress relates precisely to the responsibilities of the subsidiaries' board of directors. The Basel Committee gave the board of subsidiaries a responsibility for the protection of the interest of its depositors. However, it is an open question whether local boards will always have the incentives to proceed as prescribed by the Committee, given that they also have to look after the interest of the single shareholder.

One potential way to get local managers to look first to the subsidiaries' best interest could be to widen the ownership structure of subsidiaries. Having minority shareholders would encourage decision taking in the subsidiaries' best interest. This leads me to the second challenge I want to discuss: market discipline.

ii) Market discipline

The need to encourage market discipline as a supplement to the work of supervisors is widely recognized at the international level. However, there are at least three requirements for market discipline to work effectively in addition to the disclosure of information:

- market signals – in the form of prices – that reflect market perceptions
- instruments to enforce discipline, and
- research carried out by independent analysts.

The acquisition of local banks by global financial entities often results in the delisting of local banks from stock exchanges. When financial institutions are not listed or when they do not have a reasonable amount of subordinated outstanding debt, market participants are deprived of independent analysis and price signals.

The obvious regulatory response would be to require subsidiaries to disclose the same amount of information as if they were listed. However, the publication of relevant and timely information is only one of the requirements for market discipline to work effectively.

It has been argued that most large international banks are widely held and are thus subject to market discipline. As a corollary, their subsidiaries will be subject to the same discipline. However, this is clearly not the case.

There are some measures that would be useful in addressing these challenges. One of these, which I have already proposed, is to require large local banks to list a percentage of their equity, say 30%, on local stock markets.

This proposal has three advantages:

- First, the presence of minority shareholders in the capital structure and on the boards of large subsidiaries helps to deter parent banks from making decisions that may go against the best interests of the subsidiary.
- Second, the existence of minority shareholders also gives relevance to the work of independent board members.
- Third, the presence of minority shareholders facilitates the listing on local stock exchanges of large subsidiaries. A public listing provides market participants with price signals and instruments with which to exercise discipline.

I welcome the decision of the organizers to dedicate a session later this morning to discuss this issue

iii) Impacts of foreign regulations on domestic financial markets

Regulatory differences among home countries could have adverse impacts on host country markets. When a local bank is a subsidiary of a foreign one, it has to observe both, the local regulation and the regulations of the jurisdiction where its parent bank is incorporated.

In general, we would expect the stricter regulation to prevail. Nevertheless, subsidiaries have to consolidate their books with those of their parent banks. This means that business and trading decisions are taken with close regard to their impacts on the parent banks' balance sheets. This situation can have important adverse effects on local markets. These effects will be accentuated with the implementation of Basel II.

> <u>In addition to the widely mentioned concept of the definition of default in different countries, I can give you an example</u>: capital adequacy rules usually establish a zero risk weight on local sovereign claims denominated and funded in domestic currency.
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> Nevertheless, the new capital accord establishes risk weights on sovereign claims based on ratings provided by external credit assessment institutions or by internal rating methodologies.
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> Although the accord gives national supervisors discretion to apply lower risk weights to their domestic banks, it is very likely that subsidiaries of foreign banks will apply the capital weights established by their parent banks and by their home countries.
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> Should this happen, it will increase the financing costs of host countries' sovereign debt denominated and funded in domestic currency.

iv) The resolution of a troubled global bank

The conflicts of interest that may arise when an international bank runs into trouble have been widely analyzed in recent years and will be an important topic at this meeting.

We do not have yet any common understanding on how to deal with or resolve the failure of an international bank. Neither do we have a common jurisdiction or a supranational legal court to resolve legal disputes.

Important efforts have been made to identify the information that needs to be shared among supervisors if such a crisis arises. However, the failure of an international bank could easily lead to conflicts among the various parties involved, as their interests will diverge considerably. These conflicts could make the attainment of reasonable and fair solutions extremely difficult.

These conflicts could be particularly significant if the relative sizes of the international bank and its subsidiaries are substantially different.

- The authorities of the country where the international bank is licensed will not be very keen on supporting subsidiaries overseas, even if they are relatively important for the local country.
- On the other hand, local authorities could find it politically impossible to use public resources to support a foreign-owned bank.
- If the troubled bank experiences liquidity problems, who should be responsible for providing liquidity? The central bank of the jurisdiction where the troubled subsidiary is incorporated, or the one of the country of the parent bank?
- Will the central bank of the subsidiary provide liquidity when it is evident that the subsidiary's business was run by the parent?

It is of the essence to encourage cooperation frameworks among supervisors, central banks, and finance ministries from countries involved in extensive cross-border banking. Such frameworks should not be limited to the exchange of financial information. They must include <u>agreements over procedures</u> and the establishment of standards for the <u>division of responsibilities</u>.

In order to improve the effectiveness of crisis management plans, European Union and Scandinavian countries have been conducting crisis simulation exercises. It is important that <u>countries</u> in other regions with large subsidiaries start to conduct simulation exercises with the authorities of countries where the parents are located.

v) Competition

As mentioned, the expansion of international banks often takes place through the acquisition of existing financial entities rather than the establishment of new ones. This method of entry leaves the structure of local markets largely untouched. Efficiency gains brought about by foreign management and expertise very often result in higher profits, but not consumer benefits.

The financial authorities in Mexico have taken important steps to foster competition in the banking system by:

- promoting more transparency and disclosure,
- reducing the regulatory requirements for non-bank banks when they have no ownership relations with regulated financial entities and
- finally, by allowing new entrants into the banking system. Among them we have some commercial firms establishing banks.

Allowing commercial firms, especially in the retail sector, to own banks might bring many benefits to consumers, as well as a set of new challenges for regulators and supervisors. I would like to concentrate on this issue in the last part of my speech.

III. Commercial firms as owners of banks

In a country where the financial industry is highly concentrated and where important sectors of the population do not have access to these services, the entry of commercial firms into the banking sector can bring many benefits to consumers.

In order to compete effectively in a highly concentrated industry, new entrants must have an extended physical presence and a well-established consumer base, which many retail commercial firms in Mexico already enjoy. We expect these commercial firms to be able to exploit their economies of scale for the benefit of their consumers, contributing to a more competitive environment.

However, the participation of commercial firms as bank owners entails a series of new risks and challenges for both regulators and supervisors. These risks already receive attention in the literature on mixing banking and commerce.

One concern is the potential abuse of the safety net by commercial firms that own a bank. The conflicts of interest and potential transfer of risks between a bank and its commercial firm owner are well documented in the literature, and as we all know, are also difficult to regulate and supervise.

Early this year Alan Greenspan raised this issue when he stressed the fact that large organizations increasingly manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of supervisors.[1] For this reason, supervisors cannot properly monitor risks that cross legal entities, as some of them are not subject to financial regulation and supervision.

There are some measures that diminish the transfer of risks from a commercial firm to its bank:

i) First, by limiting related-party transactions between the bank and its commercial firm owner and requiring that their relations are conducted at market prices,

ii) Second, by aligning the incentives of banks' board members and managers. For example by requiring that the majority of banks' board members remain independent from the controlling firm or other affiliates of the conglomerate. And

iii) third, through the analyses and risk assessments of the financial positions of the entire group. In order to gain a meaningful idea of the risks of a large conglomerate, some financial authorities have suggested that supervision must cover the relevant risk positions of the

[1] Letter to Congressman James A. Leach, January 20, 2006. Board of Governors of The Federal Reserve System.

entire group. This constitutes a formidable challenge. Legal amendments would have to be made to compile basic management information on financial condition and risk exposures of the group as a whole.

It is also important to send a clear message that the bank will be able to stand alone if the commercial owner gets into trouble, and thus banks' depositors and creditors do not need to run for the exit.

Other conflicts of interest likely to surface when commercial firms become bank owners are the anticompetitive practices that commercial firms may conduct once they have a bank. For instance, commercial firms may require their suppliers to have their financial services arranged by their banks.

Banks belonging to a commercial firm may also engage in tied selling practices by, for example, extending consumer credit only for purchases made in the commercial retailer.

Finally, we should be very careful with the protection of personal data to prevent the non-authorized transfer of personal information (bank secrecy).

Final remarks

Embracing globalization brings both benefits and challenges. The evolution of the financial industry in Mexico constitutes a good example. Openness to foreign direct investment in the financial system was essential to recapitalize the banking sector and increase efficiency. It also brought other benefits, such as new technologies and products, and advanced risk management techniques.

However, it is important that the authorities continue to foster competition through transparency and disclosure, as well as new entrants to the system without increasing the risks to it.