Review of Recent Trends and Issues in Financial Sector Globalization

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The views in this presentation are those of the author and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.
Presentation outline

- Brief review of global trends in cross-border and financial sector FDI (FSFDI) activity
- Discussion of benefits, risks, and policy issues of FSFDI in emerging markets
  - Summary and update of 2004/2005 Committee on the Global Financial System reports
Financial sector globalization is being driven by many factors...

- Post-crisis recapitalization efforts in EM countries
- Broader globalization of product, services, labor and financial markets
- Ongoing liberalization, privatization, and consolidation
- Ongoing technological, communications and risk management advances
- Increased competitive pressures driving search for revenue diversification and operating scale efficiencies
...is evident in increased international bank lending,

**BIS Reporting Bank Claims on Industrialized Countries**

- Cross Border Claims
- Local Claims
- Cross Border/Total (rhs)

**BIS Reporting Bank Claims on Emerging Market Countries**

- Cross Border Claims
- Local Claims
- Cross Border/Total (rhs)

Source: BIS
...cross-border mergers and acquisitions,

Cross-border M&A deals in the financial sector

- **Emerging economies**
- **Industrialised countries**

1 Value of completed M&A deals.
2 Data covers January - 5 June, 2006.
Source: Thomson Financial
...and significant foreign bank presence in industrialized countries...

Foreign US BHC Assets by Type
($ Billions and as Percent of Total, 1995 – 1Q06)

Source: U.S. Regulatory Reports
...as well as in emerging market countries

Foreign Ownership of EM Banking Systems

<table>
<thead>
<tr>
<th>Country</th>
<th>Current</th>
<th>2001</th>
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<tbody>
<tr>
<td>Czech Republic</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Mexico</td>
<td>90%</td>
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<tr>
<td>Hungary</td>
<td>80%</td>
<td>0%</td>
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<tr>
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<td>0%</td>
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<tr>
<td>Thailand</td>
<td>10%</td>
<td>0%</td>
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<tr>
<td>China</td>
<td>10%</td>
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</tr>
</tbody>
</table>

1 Current represents the latest data available, generally Q4 2005, but ranging from Q1 2005 to Q1 2006.
Source: National Central Banks and Bank Superintendents
The globalization of banking is likely to continue

- Increased large scale cross-border acquisitions in Europe

- Wave of strategic minority stakes in Chinese banks

- Prospective further opening of individual banking markets under global or bilateral free trade agreements
Growth of global banking creates clear benefits, as well as challenges.
Benefits of global banking for EM countries
(2004/05 CGFS findings)

- Foreign bank entry leads to greater efficiency in local banking markets
  - Improved credit and risk allocation
  - Competition fosters development of local markets
- Knowledge transfer helps spread global best practice
- Acquired banks gain access to global capital markets
Challenges associated with global banking
(CGFS 2004/2005 Reports)

- Managing political sensitivities to heightened foreign participation
  - Can show up in nonregulatory barriers to entry, reflecting desires to maintain local control of banking systems and build national champions

- Achieving home/host supervisory coordination

- Dealing with local impact of decisions made on the basis of global risk/return considerations
Potential challenges to local financial systems

- Risk management and capital allocation decisions by a foreign parent of a local subsidiary bank can affect the level of capital devoted to local markets.
- Signals from key asset markets may no longer be available for acquired financial institutions:
  - Delisting of largest institutions may greatly alter local market for some instruments.
  - Acquisition of local bank by a foreign parent may reduce local analyst coverage and remove information from the price discovery process.
Financial sector supervision may become more challenging for local authorities

- Entry of increasingly complex and diverse banking organizations creates a need to enhance the know-how of local banking supervisors
  - Must develop knowledge of foreign legal, accounting and regulatory frameworks
  - Financial and technical skills of supervisors must be enhanced
- Creates need for more and better cross-border information-sharing among supervisors
The baseline: strengthening bank supervision

Compliance with Basel Core Principles

Error bars denote maximum and minimum observations.
Source: IMF, 2004
Supervisory information-sharing is essential

- Substantial work by Basel Committee, Joint Forum on information-sharing principles
- Information flows host to home should be largely unimpeded; home to host should be as forthright as possible
- Active dialogue and coordination is under way between G-10 and non-G10 supervisors on Basel II home/host issues
Mechanisms needed to promote financial stability

- Stronger institutions are key, regardless of ownership of banks
- Robust legal, accounting and supervisory frameworks are critical
- Standards such as FSAPs and ROSCs provide independent view on vulnerabilities and development challenges, and can enhance market transparency
- Regional compacts such as EU, NAFTA can foster development of supporting legal, market, and regulatory infrastructure
Questions for panel discussion

- What are the main factors behind recent sensitivity to foreign bank investment in some countries?
  - Lessons for policymakers?

- What are the appropriate goals and behaviors of foreign banks in host markets?
  - Balancing local and parent interests
  - What mechanisms can be most effective in achieving local representation in foreign bank governance?
Questions for panel discussion (continued)

- What role can market discipline play in ensuring the interests of all stakeholders are considered by the management of global banking institutions?
  - What mechanisms are most effective in ensuring market discipline’s influence?

- What implications are seen for supervisory policy?
  - Frequency and quality of disclosure (Basel II)
  - Improvements in accounting infrastructure
  - Roles of home vs. host country authorities
  - Other?