BANCO DE ESPAÑA

Comments on “Financial globalisation, governance, and the evolution of the Home Bias”, by B. Kho, R. Stulz and E. Warnock

José Viñals
Banco de España

FIFTH BIS ANNUAL CONFERENCE

Brunnen, Switzerland
20 June, 2006

What the Paper Does and Does Not Do

- **What it does:**
  - **Provides an innovative approach to explaining the still unresolved "puzzle" of the HB in global asset portfolios**
  - **Proposes as explanation for the HB an interesting combination of the Portfolio Model and the Corporate Finance theory of Optimal Insider Ownership**
  - **Adds a new interpretation to the existence HB in equity markets highlighting the role of governance and institutions, and the relationship between these and corporate ownership concentration.**
- **What it does not:**
  - **Adress HB in bond markets, where it also prevails and is even higher than for equities**

The optimal insider ownership theory of equity HB
The hypothesis to be tested

Two competing forces linking HB to optimal insider ownership:

- **A direct channel from insider ownership to foreign holdings : availability of shares**
- **An incentive-driven channel**

The optimal insider ownership theory of equity HB
The evidence using holdings of US investors

- **Evidence supports the first channel (availability)**
  - **HB decreases when the fraction of market's capitalization available to foreign investors increases**
- **Evidence does not support the second channel (incentives)**
  - **Using the float-adjusted portfolios, governance and institutions not significant in accounting for the HB.**

⇨ Governance and institutions matter for HB but only through the first channel.

The optimal insider ownership theory of equity HB
The evidence in the Korean case

- Evidence supports the first channel (availability)
  - Foreign ownership of Korean firms increase when the fraction of market's capitalization available to foreign investors increases.
- But evidence also supports direct role of governance in HB (over and above its impact on insider ownership).

The optimal insider ownership theory of equity HB
Comments on the results

- **Interesting that (national) governance does not directly influence HB in US investors case but (corporate) governance does influence HB in the Korean case ⇨to be explored further**

- **Can foreigners also play an insider role (as third related party)?**

- **It would be interesting not just look at US data but also to other countries (cross sectional analysis for a given year) to see if the "US-investor based" evidence is confirmed or, if there are differences, why is so.**

- **It would be interesting to run a 2-equation rather than a 1-equation model:**

  (1) HB = f (insider ownership, others)

  (2) insider ownership = g (institutional and governance variables)

- **Important role of local financial markets development (liquidity).**

Going beyond the paper

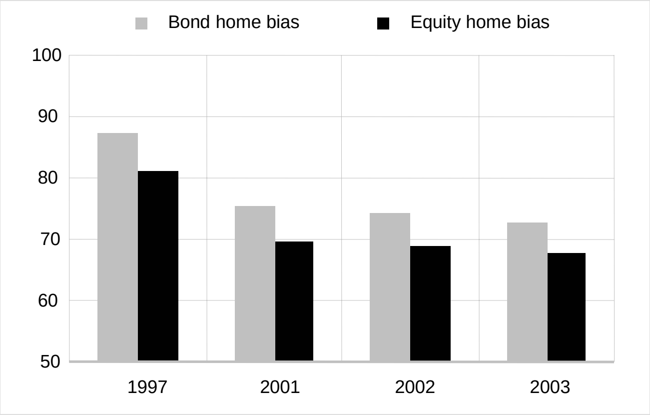
- Is there value in looking at different regional groupings?

- How about HB in bond markets?

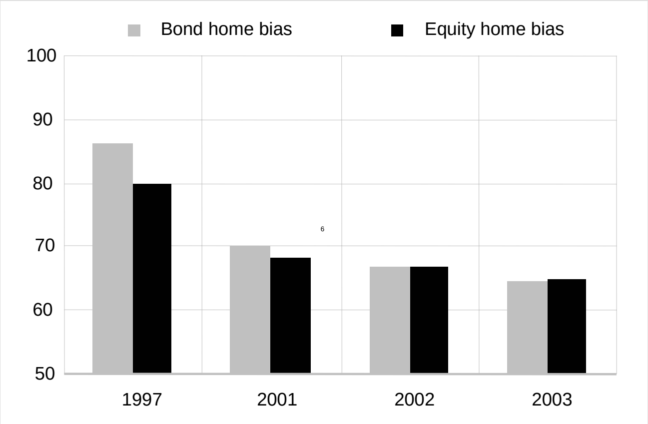
⇨The case of the euro area: changes in HB in equity and bond markets

Bond and Equity HB (CPIS)
HB declining, albeit unevenly across areas and asset-classes

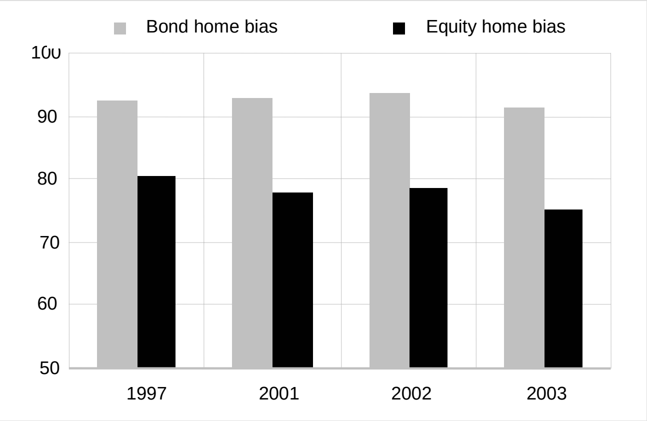
Mature economies



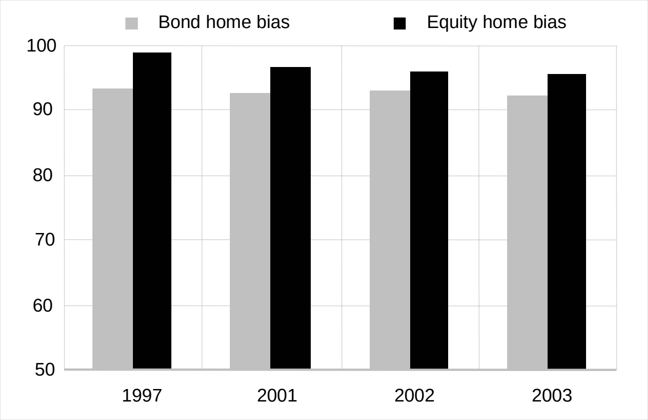
Euro area economies



United States



Emerging economies

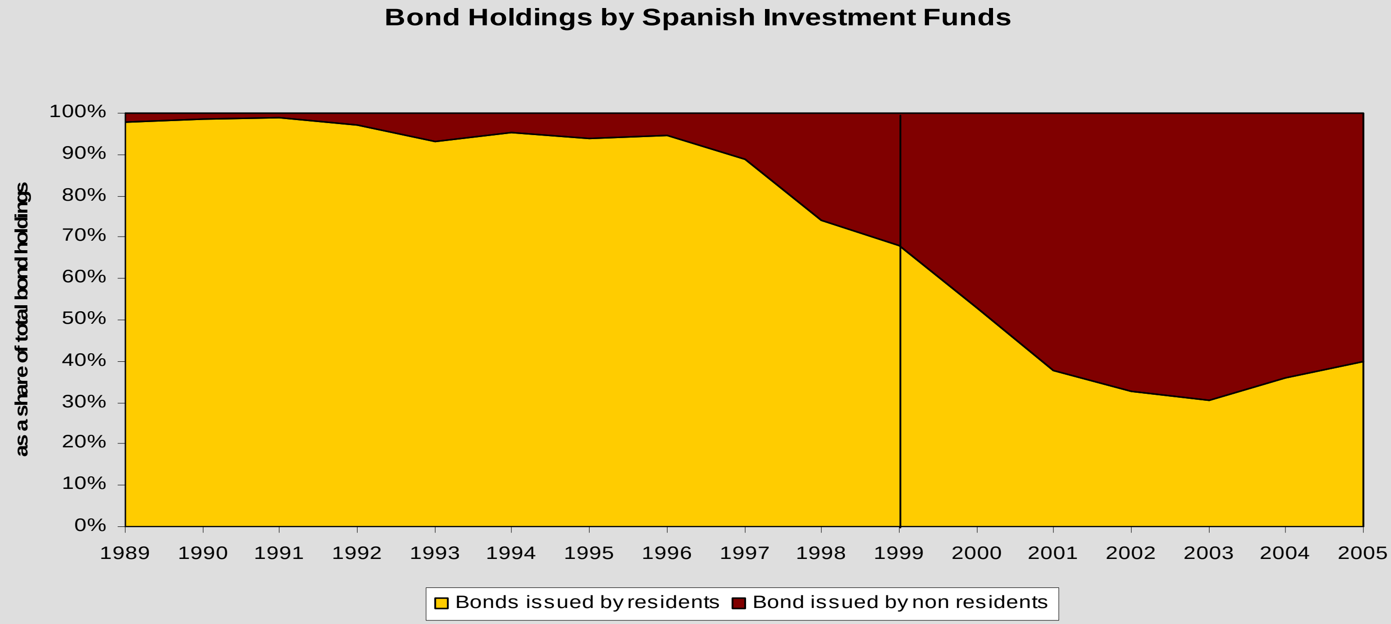


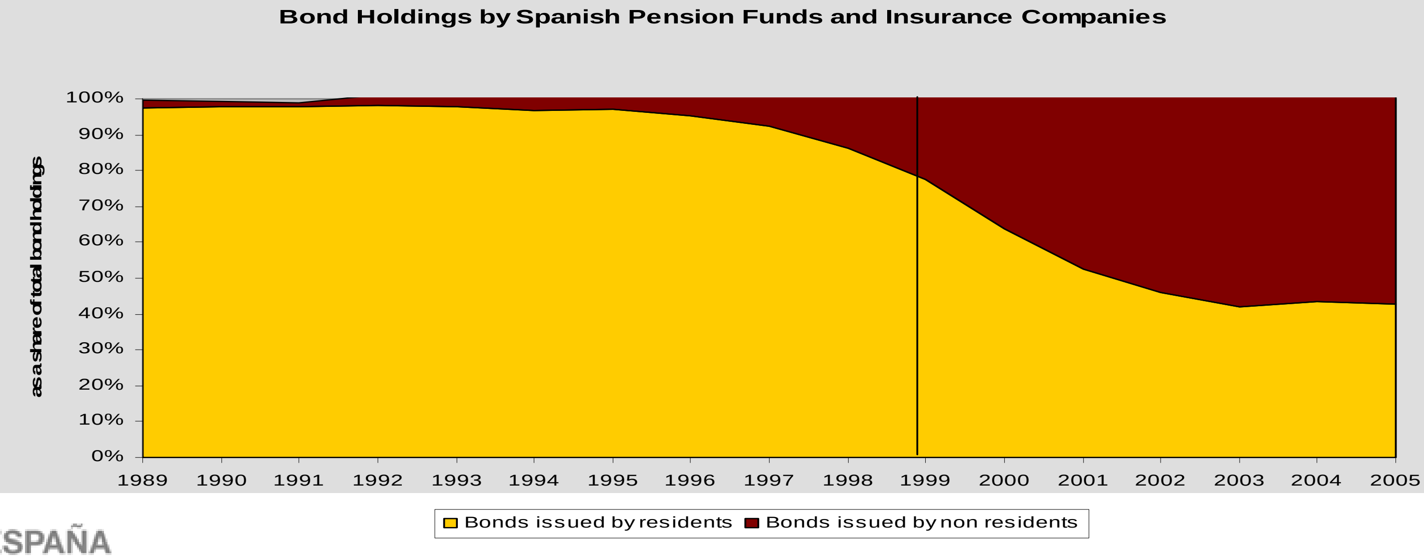
Source: ECB based on IMF CPIS.

Based on the CPIS survey (1997-2003)

- HB is still rather high (>60%) worldwide
- However, HB has declined much more among mature economies than emerging market economies
- Within mature economies, HB has fallen substantially in the euro area and not as much in the US, where HB has remained rather stable especially in bonds.
- In the euro area, it is HB in bonds that has dropped more prominently

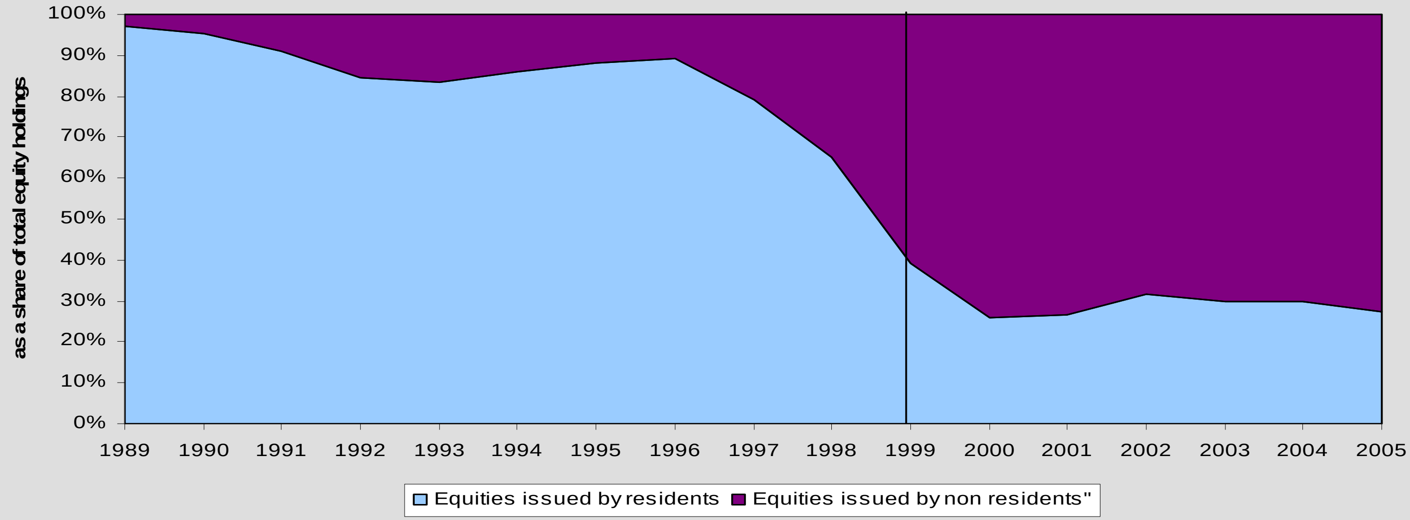
Another way to look at HB: the internationalization of porftolios of institutional investors



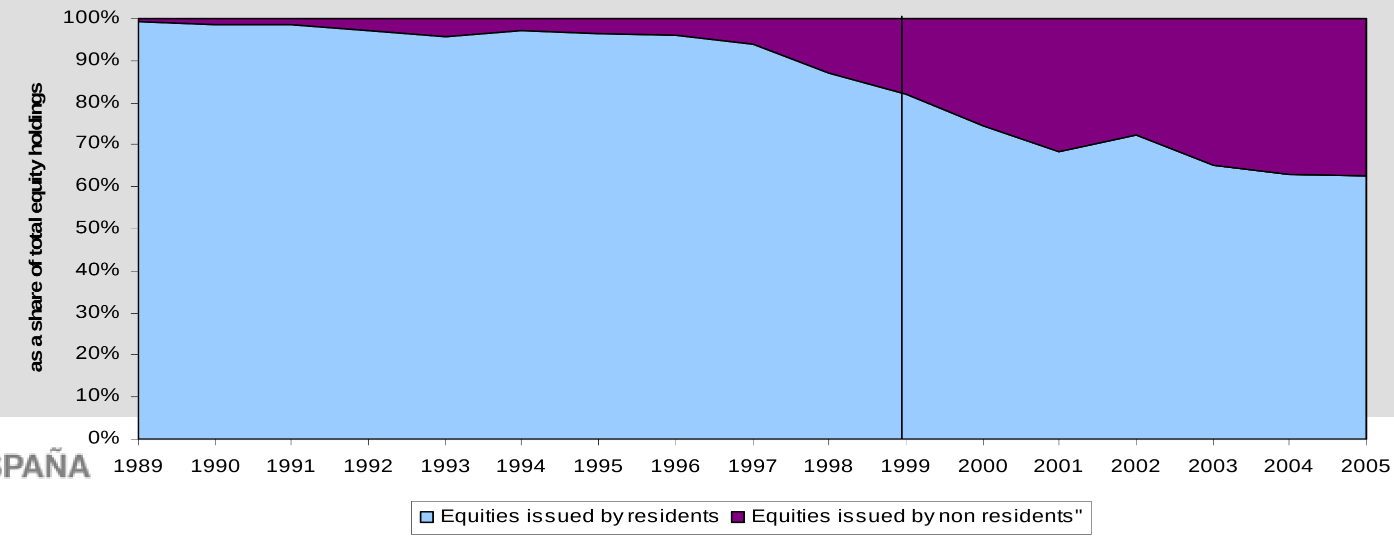


Another way to look at HB: the internationalization of porftolios of institutional investors

Equity Holdings by Spanish Investment Funds



Equity Holdings by Spanish Pension Funds and Insurance Companies



HB in bond markets

- Two types: government bonds and corporate bonds
- Government bonds
  - Ownership concentration not relevant for explaining HB
  - Strong evidence that macro policies,institutions and governance do matter for HB
- Corporate bonds
  - Ownership concentration not relevant directly since no “availability” effects
  - Still, ownership concentration could be relevant in so far as it relates to the extraction of private benefits by the insider and thus might affect the firm’s credit standings
- Unfortunately, CPIS does not allow separately testing for government and corporate bonds HBs

Explanations for the reduction in HB, primarily in Europe (bonds and equities).

- Euro area is the group of countries where insider ownership has fallen the most
- Alternative explanations to K-S-W- based on portfolio theory+other elements (macro, institutional)
- According to De Santis and Gerard (2006)
  - EMU and, in particular, its institutional framework, is main determinant of reduction in HB, having eased the access primarily to bond markets, and also to equity markets.
  - Result: greater regional financial integration in the euro area
  - Powerful role of institutions
- According to Lane (2005)
  - Regional financial integration is leading financial globalization.
  - Euro area bias in bond markets: euro area countries invest disproportionately in one another relative to other country pairs.
  - Positive connection between trade linkages and financial linkages
  - Powerful role of institutions
- Fidora, Fratzscher and Thimann (2006)
  - Real exchange rate volatility is a key driver of portfolio HB at the global level for both bonds and equities.
  - A reduction in volatility sharply reduces HB in equities, and even more in bonds.
  - Role for macro policies.

Policy Implications

- In general, so long as correlations among different asset classes and domestic and foreign assets remain imperfect, there are gains to be made from international portfolio diversification, and therefore, from a reduction in HB
- Lower HB also means better risk sharing across countries and in this way it should enhance global financial stability
- The paper rightly highlights the importance of improved institutions and improved governance for financial integration
- What else can be done to reduce HB?
  - Improve financial markets infrastructure (legal, operational)
  - Improve market discipline through the development of
    - *diverse investor base (for instance through institutional investors)*
    - *Increase transparency and disclosure*
- Macro policies
- Better institutions and financial integration reinforce each other and help promote economic growth