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16 June 2003

Direct Investment in Emerging Market Economies:

The Experience of Canadian Banks

1. Introduction

This note provides a short summary of some interviews that were held earlier this year with two Canadian commercial banks -- the Canadian Imperial Bank of Commerce (CIBC) and the Bank of Nova Scotia (Scotia). The purpose of the interviews was to review the banks' experience with direct investment in emerging market economies and to see what lessons might be learned with regard to the challenges that they face as well as the prospective role for public policy in this area. One of the banks that was interviewed, the Scotia, began investing in emerging market economies in the early 1800s, and is a strong proponent of foreign direct investment. The other bank, CIBC, is more typical of Canadian commercial banks, and maintains a wary attitude towards foreign direct investment. Its interest has fluctuated over time in response to changing market conditions, and is currently in a down phase.

The note begins with some background information on the direct investment activities of Canadian banks, and then examines the experience of the CIBC and Scotia in greater detail. The picture that emerges is one of sharp contrasts, in which foreign direct investment is variously cast as (i) a constant source of frustration and disappointment, and (ii) an important source of profit and risk diversification.

2. Some Background Information

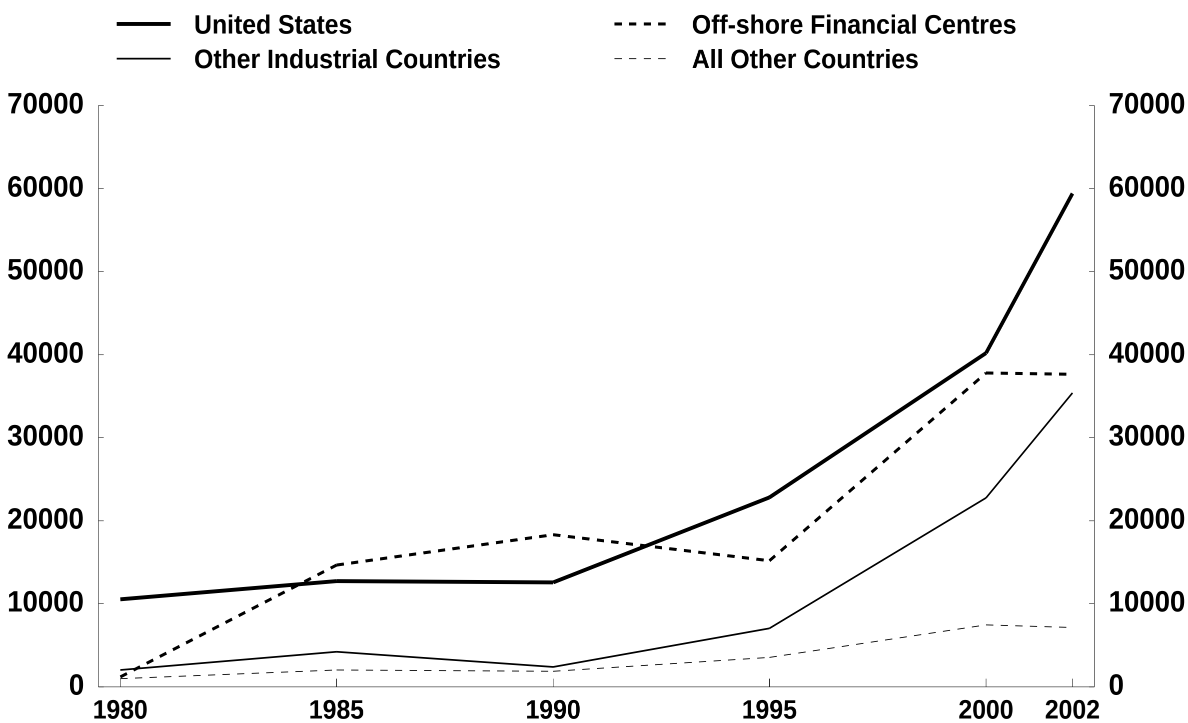
The 6 major Canadian banks hold approximately $140 billion (Cdn.) in long-term claims on foreign branches, agencies and consolidated subsidiaries. However, most of these investments are concentrated in the United States and other industrial countries, as well as a few off-shore financial centres. Long-term claims on all other countries, including EMEs, amounted to only $7.2 billion in 2002 (or roughly 5 per cent of the total). Although most Canadian banks have some direct involvement in EMEs, the Scotia is by far the most important player. The CIBC is the second most important participant, but it is active in only a few foreign countries and is currently concentrating most of its energies on markets closer to home.

The general pattern and relative importance of the banks' foreign direct investment activities are shown in Figure 1, which plots "head office claims on foreign branches, agencies and consolidated subsidiaries" over the period 1980 to 2002. As the reader can see, investments in the United States alone typically account for more than 40 per cent of total direct investment. All of the lines have been drifting upward through time; however, the line for "all other countries" has generally shown somewhat slower growth and has been subject to more downward blips -- indicative perhaps of the changing market sentiment regarding investment in EMEs.

Figure 1

Foreign Direct Investment by Canadian Banks (1980-2002)

millions of dollars



3. The Canadian Imperial Bank of Commerce

The CIBC maintains a continuing interest in EMEs, but its direct investments are at present concentrated in only two countries (or economic zones) -- Hong Kong and the Philippines. The concerns that it expressed in the interview about the risks that foreign banks face when trying to establish a presence in foreign markets are probably reflective of those held by many other Canadian banks.

(a) The Importance of Size

The CIBC suggested that it was extremely difficult for medium-sized banks from smaller industrial countries to compete effectively with much larger financial institutions from major industrial powers. Smaller institutions were unable to capture significant economies of scale and had a lower risk tolerance, owing to their limited capital base. Only 15 to 20 banks in the global economy had the necessary capital and size, in the CIBC's opinion, to play effectively in this area. The CIBC also suggested that larger banks, or at least those from larger countries, might have additional advantage, owing to the increased attention and assistance that they received from international financial institutions. Medium-sized banks from smaller countries, in contrast, posed fewer risks to the international financial system and hence attracted less attention. These hurdles could be overcome if smaller banks had other advantages to trade on, such as strong colonial ties or a cultural/linguistic connection, but Canada was not well placed in this regard.

(b) A Catch-22

Direct investment in industrial countries, such as the United Kingdom or the United States, was often viewed as necessary simply to service domestic customers or to preserve the competitive position of the Canadian bank in its home market. It also provided important advantages, vis-a-vis investments in EMEs, because of the evident stability of industrial country markets. Efficient markets structures and a more reliable legal system eliminated many of the problems that banks faced in less developed countries. The competition that new entrants faced in industrial countries was more intense, however, and the profit margins were extremely slim. New banks were often forced to concentrate on the weakest and least creditworthy segments of the foreign market, and also had to finance most of their overseas operations with expensive money market instruments.

Profit margins in emerging markets economies were typically wider, and competitive pressures were often less intense than in industrial countries. The down side to these advantages was the fact that institutional infra-structures and legal systems in these countries were also less developed, increasing the chances that everything would be lost to some unforeseen risk. Forming a joint partnership or alliance with a local institution might reduce these risks and yield important information concerning the idiosyncrasies of the foreign market, but these relationships often carried their own set of problems. A notable exception to this rule was the profitable and long standing relationship that the CIBC had enjoyed with a well-connected individual in the Hong Kong business community. In CIBC's opinion, however, these positive experiences were the exception rather than the rule.

(c) Operational Biases and Unforeseen Expenses

Part of our discussion with CIBC focused on its experience in Australia and New Zealand. While these countries lie well outside the EME category, the challenges that CIBC faced were regarded as instructive. CIBC decided to enter the Australian market because some of its larger corporate customers were active in the area. It also had a number of customers in New Zealand, which CIBC initially decided to serve from Australia. In the late-1980s, however, banking licences in New Zealand became more readily available, so a decision was made to establish a local presence in New Zealand and to try and attract some additional business. Three years later, CIBC decided to reduce the scale of its operations in both countries, following a number of unsettling events and financial setbacks.

Three major lessons were drawn from this experience. First, foreign offices are more expensive to operate than one imagines. Second, loan officers in the foreign country are almost always too optimistic concerning the prospects for the local market. Three, the views of local managers often carry more weight than the views of head office, leading to biased business decisions.

(d) Other Related Issues

The motivation for CIBC's foreign direct investment activities varied through time and across countries. Some decisions, such as the one related to Australia and New Zealand, were driven by customers demands. The same was true of the CIBC's activities in the Caribbean. Other initiatives, such as the decision to enter a number of countries in Asia in the early 1990s, were based on competitive pressures and the perceived need to keep pace with other Canadian banks. Some recognition was given to the potential gains afforded by international diversification, but this was not regarded as a major consideration. The prospective returns from each investment were more important, while risk considerations were clearly secondary. History was an unreliable guide with regard to trying to quantify these elements, since the covariance structure of returns tended to shift dramatically in periods of crisis. "When things went bad in one country, they typically went bad in every country." The primary concern in turbulent times is liquidity rather than diversification; but few EMEs offer deep and liquid markets.

One means of dealing with these risks is to form a partnership with another, more experienced, financial institution from an industrial country -- assuming an acceptable and willing partner can be found. This is the strategy that CIBC has pursued in the Caribbean with Barclays. (While CIBC had an active customer base that it could trade on, there was limited scope for capturing economies of scale or diversifying its portfolio, since the only local investments were in tourism and real estate.)

Branch operations were regarded by CIBC as preferable to subsidiaries, since they reduced the need to post bonds or raise funds domestically, as was often required with subsidiaries. However, some countries place significant restrictions on the allowable activities of branches, as well as the share of the domestic market that they are allowed to occupy. CIBC felt that the international community in general, and IFIs in particular, had a useful role to play in ensuring more even-handed treatment in EMEs and improving the institutional infra-structure in these countries. Efforts to promote codes and standards were well received, as were the other activities of the IMF designed to prevent and resolve international financial crises. A more comprehensive and readily available system of guarantees and international insurance was noted as an interesting possibility, but there was little expectation that such a system would ever be put in place. Some insurance for specific types of risk was already offered by institutions such as the World Bank and various domestic export credit agencies, but official assistance was unlikely to go much further.

4. Scotia Bank

The views of Scotia Bank regarding foreign direct investment were more upbeat than those of CIBC. International trade financing and investment have been an important part of Scotia's activities since the early 1800s, when it was first established. This strong international connection was largely an accident of geography and opportunity in the 19th century, since Nova Scotia (where the bank was originally based) was at the central of the triangle-trade that linked the United Kingdom and the Caribbean Islands to the east coast of North America. While Scotia is sensitive to the risks associated with direct investment in EMEs, they believe the rewards are high enough to justify the exposure.

(a) Profits and Market Share

The key drivers of Scotia's foreign direct investment activities are profit and market share, as opposed to diversification. In this sense their views are much like those of CIBC. Most of Scotia's direct investments are in the Caribbean and Latin America, reflecting its early roots -- although sizable books have also been established in a few Asian countries, such as Hong Kong, Malaysia, Thailand and Korea (where most of the focus is on corporate lending). Since Scotia did not have the capital necessary to buy existing firms, it opted either to establish its own institutions and wait for them to grow ("green fields investment") or to form partnerships with local firms. The latter strategy, as noted earlier, carries both benefits and costs. While local firms can provide specialized expertise and some protection from arbitrary political actions, and they have not always proven to be the most reliable allies in times of difficulty.

Recent events in Argentina serve as a useful example of the sorts of problems that can result even when the initial conditions appear quite positive.

(b) Quilmes and the Hazards of Foreign Direct Investment

Many of the details concerning Scotia's unfortunate experience in Argentina are by now well known, and will not be dealt with here. Suffice it to say that the process surrounding foreign direct investment is seldom easy even when one has the support of a local institution and a strong reserve position. Scotia had originally planned to operate Quilmes as a partnership. It bought a significant, but less than majority, interest in the local bank and assumed that this relationship would remain unchanged for a long period of time. Quilmes was one of the largest financial institutions in Argentina and had an extensive branch network.

A short time after the deal was consummated, however, Scotia discovered that most of the capital reported by Quilmes' parent was of doubtful quality. As a consequence, Scotia was forced to buy-out its partner and to assume exclusive responsibility for the capital deficiency. Within a short period of time (and at considerable expense), the subsidiary was soon showing a profit and operating efficiently.

The crisis that unfolded in Argentina through 2001 and 2002 did not seem to pose a major problem for Quilmes initially. The institution had sizable reserves and was regarded as one of the strongest in the local market. These advantages were not sufficient, however, to cope with the uneven treatment that the Argentine government accorded some foreign owned banks during this period. Asymmetric peso-ization, coupled with unequal access to the discount window, made it impossible to continue operations. In the end Scotia decided to close its local operations, and find a local buyer for the remaining firm, rather than contribute additional capital from head office.

(c) Some Lesson from Quilmes and Other Foreign Direct Investments

It is important to note that the experience in Argentina has not changed Scotia's views concerning the potential benefits of foreign direct investment. A short time after Scotia withdrew from Argentina, it moved to increase its stake in Inverlat, the sixth largest bank in Mexico. Although Scotia had to take a significant right-down in 2002, because of its losses in Argentina, earlier profits realized in this and other countries more than made up for this one-time charge. The benefit-cost ratio in Scotia's view is still very large and positive.

In order to minimize the risks associated with FDI, Scotia has formulated the the following investment strategy. First, it tries to run a matched book -- raising most of the financing it needs locally, and investing it locally as well. Loss ratios on cross-border loans are often much larger than local loans owing to currency mismatches as well as heightened credit and market risk. Second, Scotia's local operations are typically set up as subsidiaries rather than branches. This, in Scotia's view, is a much cleaner way of operating and limits possible claims on the parent if the investment runs into difficulty. Third, Scotia is very cautious about foreign partnerships -- whether private or public. Some governments demand local participation, so Scotia would not preclude such relationships in the future. However, their preference is to “go it alone.” Fourth, most credit adjudication is done at Scotia’s head office in order to avoid the sort of bias noted by CIBC. While local input is an important part of the final investment decision, Scotia is worried about the susceptibility of local managers to “capture.”

(d) Other Related Issues

Scotia does not believe that economies of scale are as important as some observers suggest. They are significant for certain operations, such as cheque processing, but these activities are usually out-sourced anyway. Patience and watchfulness are the two most critical traits of a successful foreign investor, in Scotia’s opinion. Trying to grow the business too quickly and forming unfortunate alliances are two of the most frequent errors.

Scotia also sees an important role for the international community in crisis prevention and resolution. They have been a strong supporter of the Institute of International Finance, and feel that the existing game plan for dealing with crises should remain largely unchanged. Like most other commercial banks they are extremely wary of more “interventionist” and ambitious initiatives such as the Sovereign Debt Restructuring Mechanism. A system of international guarantees and insurance against international crises would be attractive, but is probably unrealistic at the present time. While AMBAC does provide some protection against political risk, as does the Export Development Corporation in Canada, Scotia believes that commercial banks are essentially on their own whenever they venture into EMEs and that this is the way it should be.

5. Conclusion

Two major conclusions can be drawn from our discussions with Canadian commercial banks. The first is that recent events have not affected their attitude towards foreign direct investment materially. Their prospective interest in foreign direct investment remains largely unchanged. Those banks which were early proponents of FDI are still engaged in it and have plans to continue; those institutions which were less enthusiastic have had their suspicions confirmed.

The second conclusion is that banks appreciate the role that the official sector has played in crisis prevention and resolution, but are sceptical of the new, more interventionist, proposals that have recently been put forward. Guarantees and takeouts would be nice, but are both unrealistic and unnecessary. Foreign direct investment in EMEs is not for the faint-hearted, but high rates of return can be realized by those who are willing to bear the risks.