Foreign banks entry in emerging market economies: a host country perspective.

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Introduction

During the last decade several emerging market economies (EME) have lifted restrictions on foreign direct investment (FDI) in their financial systems. As a result, foreign ownership of domestic institutions has been growing rapidly. Today, in many Latin American as well as Central and Eastern European countries foreign banks control more than 50 percent of their banking system's assets.[1]

Some impacts of foreign bank entry have been thoroughly studied (see for example Clarke et al (2001)), while others are seldom mentioned. The aim of this paper consists in highlighting some policy-oriented issues that have arisen with the entry of foreign banks in emerging market economies from the point of view of a host country. The first part of the paper introduces some empirical studies on foreign banks' entry and its implications for local financial systems and economies; the second, deals with effects on the soundness of local entities and the third, discusses possible adverse effects on market discipline. Finally, some conclusions are drawn in the last section.

1.- Impacts of FDI in host countries financial systems and economies.

The entry of foreign banks brings large benefits to host countries' financial systems and economies at large. Benefits stem from efficiency gains brought about by new technologies, products and management techniques as well as from increased competition stimulated by new entrants. Moreover, as foreign banks may have greater access to resources from abroad, they have more stable funding and lending patterns than domestic banks. They also hold a more geographically diversified credit portfolio and hence would not be as affected during periods of stress in the host country. Another important issue for EME is related to impacts on connected lending practices by banks. In EME where wealth is highly concentrated it is common that banks' board members, stockholders and large borrowers are closely related. Foreign banks do not get involved in connected lending both because they do not have related parties in the host country and their widely held equity structure does not encourage this kind of behavior (Goldberg et al (2000), Hanousek (2001), IMF

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[1] For example, Argentina, Brazil, Bulgaria, Chile, Slovak Republic, Estonia, Hungary, Latvia, Lithuania, Mexico, New Zealand, Poland, Czech Republic and Romania (Thiman et al (2002)).

(2000), La Porta et al (2001) and Levine (1996)).[2] It is also worth mentioning that foreign banks brought new capital to many EME which experienced severe financial crises and that they also import supervision from their home country authorities.

At the same time, foreign investment in the financial sector rises some concerns. The greater participation of foreign institutions might expose host economies to events taking place in other countries where their foreign banks operate. On one hand, international banks have access to more investment alternatives and thus are more prone to "cut and run" than domestically owned banks when their investments are not performing as expected. On the other hand, local stockholders in EME face greater transactions costs and usually have vested interest that prevent them from unloading their financial investments. Further concerns arise because modern technologies used by large foreign banks rely mainly on hard data not always available in EME specially for small and medium enterprises; therefore banks could end up rationing credit to this type of firms or increasing risks borne by domestic institutions attempting to serve more opaque customers as a result of greater competition.

International banks might also engage in regulatory arbitrage seizing differences in regulations around the world. Host country regulators may be overwhelmed by the complexities associated with the supervision of large and complex financial institutions, understanding new products and operations and by difficulties to achieve effective coordination with their counterparts located in home or other host countries. Conflicts of interests among parent companies and their subsidiaries may arise from management actions –on the host country- seeking to pursue solely the interests of the former. Lastly, foreign banks may also negatively affect the depth, liquidity and information available to market participants when they de-list shares of acquired institutions.

1.1 Competition and efficiency

Recent studies (Claessens et al (2001))[3] found differences in the impact from foreign bank entry on banking efficiency in EME and in industrialized countries. In EME, subsidiaries of foreign banks enjoy higher interest rate margins and profitability than domestically owned banks, whereas in industrialized economies the opposite is true. These studies also found that significant foreign bank presence is associated with a reduction in margins, profitability and overall expenses in domestically owned banks. Furthermore, the efficiency effects of foreign bank entry on banking systems appear to occur as soon as the entry takes place and do not depend on market share.[4] Studies of the experiences of Argentina,

[2] In many EME the number of listed companies is rather small, moreover, ownership concentration is high and reflects the significant wealth concentration in these economies. For example, a recent study of firms listed in stock markets by the Institute for International Finance mentions Greece, Colombia and Mexico as the countries with the highest ownership concentration levels in the world (IIF (2003)).

[3] The authors examined the behavior of banks in 80 EME and industrialized countries from 1988 to 1995 to investigate how net interest rate margins, overhead expenses and profitability differed between foreign and domestic banks.

[4] Hermes and Lensink (2002) replicate the analysis of Claessens et al (2001) on the effects of foreign entry on profitability, costs and income of domestic banks but they report results only for a subset of emerging market economies. According to their estimates, the effects of foreign bank entry on interest margins and costs are

Colombia, Turkey, Australia, France, Germany, Spain, the United Kingdom, and United States support these conclusions (Clarke et al (1999), Barajas et al (1999), Denizer (2000), McFadden (1994), and Berger et al (2000)). The effects on markets may stem from both the actual entry of new competitors, as well as a consequence on the increased likelihood of new entries to the industry in pursue of high profits (i.e. market contestability).

These contrasting results could be explained by the different origin of the mergers and acquisitions which take place in EME and industrialized countries. Foreign bank entry in EME has been the result of dealing with financial crises, while in mature economies foreign entry comes from competitive pressures. In contrast with industrialized countries, in EME, cross-border mergers and acquisitions have led to an increase of concentration indexes.

Gelos and Roldos (2002) show that despite the increase in concentration after foreign bank entry during 1994-1997 in countries such as Mexico and Turkey, the intensity of competition did not decline. Further research for the Mexican banking system proved that during 1997-2002 there was a decline in competitive pressures (Dueñas (2003)). However, in the case of Mexico it might be too early to observe effects in competition arising from the bank mergers which also took place during those years.

Foreign bank presence may also foster efficiency and development of domestic financial markets by increasing the number of financial products available to local customers through imported technologies and know-how. An example of this is the role played by foreign banks in derivatives markets in Mexico. While their participation in total assets is 82 percent, their share in derivatives operations (measured by the notional amount of operations performed by banks) is 94 percent. Small foreign banks[5] play a major role in lending to the corporate sector, and in the derivatives, government securities and money markets. The majority of these affiliates operate from a single office located in Mexico City and offer a wide range of tailor-made products for large corporate customers. Although they hold only four percent of assets in the banking system, their share in derivatives markets is 33 percent. Furthermore, in the course of the last year four out of six market makers, selected on a quarterly basis by the ministry of finance, were small foreign banks.

It is also worth mentioning that recent research on competition in the banking industry highlights the presence of foreign owned institutions as a mitigating factor of the possible negative effects of increased market concentration. For example, Beck et al (2003) found that concentration increases firms' financing obstacles, however the effect is dampened in countries with a larger share of foreign owned banks.

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non-linear, with an inverted U-shape, which might suggest that the effects of increased competition and efficiency only take place after the extent of foreign bank entry has reached a certain minimum level. The aforementioned evidence also suggests that the impact of foreign entry may be different for industrialized and emerging market economies. The last is consistent with findings in a study by Buch (2000) for transition economies.

[5] Banks with a market share, based on total assets, not greater than 1.5 percent were classified as small.

1.2 Stability, diversification and contagion.

The increasing globalization of financial markets and corporate links across economies have augmented the speed at which events in one market may affect others. Subsidiaries of foreign banks can be a source of stability during periods of local stress,[6] as they are part of globally diversified entities. However, they can also be a source of contagion from events taking place somewhere else, as they serve as transmission mechanisms for the policies adopted by their stockholders in response to shocks in their home country or in other places where they have investments.

The stability of foreign bank lending has been examined by contrasting the behavior of cross-border and local lending by foreign banks during crisis periods. It seems that foreign large banks that have established a local presence (e.g. branches or subsidiaries) are less likely to reduce their exposition or to "cut and run" during crisis periods, perhaps due to large fixed costs of establishing a branch network and gaining market share. Peek et al (2000) found that offshore lending was more volatile than onshore lending for Brazil, Argentina and Mexico, the same pattern was found for Central and Eastern European countries by de Hass and van Lelyveld (2002).

Goldberg et al (2000) examined the lending behavior of foreign and domestic banks in Argentina and Mexico in the period 1994 to 1998. They concluded that foreign banks exhibited stronger loan growth with lower associated volatility compared to all domestic owned banks, and thereby contributed to greater stability in credit. Nevertheless, they recognized that bank soundness, and not ownership *per se*, was also an important element in the growth and volatility of bank credit. The onshore presence of foreign banks may also foster stability of the deposit base by allowing domestic depositors to do their "flight to quality" at home[7] [8] (see Clarke et al (2000)), indeed Demirgüç-Kunt et al (1998) found evidence suggesting that the increased participation of foreign banks tends to lower the probability of a banking crisis.

Empirical evidence on contagion was found by Peek and Rosengren (1997, 2000) who showed that financial problems in Japan, during the late 80s and early 90s, were transmitted to the US through Japanese banks' operations in the American mortgage markets. Furthermore, Goldberg et al (2001) found that the onshore and offshore exposures of US banks to emerging market economies were more responsive to economic conditions in the US than to emerging markets growth and interest rates.

In addition, when ownership of a banking system is highly concentrated in a single foreign country, an adverse shock to that foreign country could easily spill-over and engulf the host

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[6] Goldberg et al (2000) shows that credit granted by foreign banks in Argentina and Mexico was more stable than credit granted by locally-owned banks. However, they also found that well capitalized banks were also able to sustain their credit activities after crises periods.

[7] Clarke et al (2000) shows that deposits in foreign banks in Argentina were increasing during the mid-1990s financial turmoil. According to Kraft (2002) foreign bank subsidiaries acted as havens for depositors during the Croatian banking crisis of 1998.

[8] Unfortunately, this does not guarantee that in times of stress funds will not be transferred abroad in order to finance projects with higher risk-adjusted profits, thus creating a credit crunch in the domestic market.

country economy. But if FDI comes from various countries not closely interrelated, then the result will be a banking system with the corresponding benefits that come from risk diversification. Hull (2002) explores the implications of a large presence of foreign banks in the New Zealand banking system, where the five largest banks represented over 90 percent of New Zealand banks' assets, and four of these five banks were Australian. She concludes that given the high concentration of ownership by Australian investors, and the interdependence between the Australian and New Zealand economies, financial instabilities in Australia could adversely affect New Zealand. She also highlights the possibility that, given the close relation of these economies, in some circumstances the Australian parent companies may lack the ability to provide stability in a crisis.

Chart 1
Participation of state, private and foreign banks in banking systems[1]

Region/Country	State banks	Private banks	Foreign banks				Single largest foreign country
			Total	EU	USA	Other	
Latin America							
Argentina	32.5	19.1	48.4	33.6	12.1	2.7	Spain (17.9%)
Brazil	46.0	27.0	27.0	15.7	5.3	6.1	Spain (5.3%)
Bolivia	18.2	56.5	25.3	10.4	4.5	10.4	Spain (10.4%)
Chile	12.9	45.5	41.6	32.4	5.5	3.8	Spain (30.6%)
Peru	10.8	43.2	46.0	34.8	5.6	5.6	Spain (17.1%)
Mexico	-	17.7	82.3	53.7	23.7	4.8	Spain (41.5%)
Eastern Europe							
Rumania[2]	41.8	3.0	54.9	46.0	4.5	4.4	Austria (21.7%)
Poland	23.1	5.4	71.5	60.2	10.4	0.9	Italy (16.6%)
Slovakia[2]	33.0	6.4	60.5	51.8	2.8	5.9	Luxembourg (34.9%)
Bulgaria	18.1	10.3	72.0	62.9	1.3	7.8	Italy (27%)
Czech Republic[2]	4.3	25.7	70.0	58.1	6.3	5.6	Austria (40.5%)
Estonia	-	2.0	98.0	98.0	-	-	Sweden (86.3%)
Hungary	44.6	3.2	52.2	39.2	8.6	4.4	Austria (17.8%)
Slovenia	14.3	19.6	66.2	66.2	-	-	Belgium (44.5%)

[1] Note: Participation in terms of assets in each country's banking industry. Participation is considered to be 100 percent when a foreign bank controls a bank but owns less than 100 percent of the capital.
[2] Participation in terms of capital.
Source: Bankers Almanac and National Publications.

In several countries of Latin America, Spanish banks have acquired important positions (see Chart 1), giving rise to concerns that contagion from a crisis in one country may work through investment decisions of these banks.[9] In 2002, for example and probably influenced by their severe losses in Argentina, BBVA sold the equity of its Brazilian

[9] In December 2002, around 30 percent of BBVA's assets were in Latin America and almost 35 percent of profits were originated in the same region (BBVA Annual Report 2002). SCH also derived 35 percent of its profits from Latin America during the same year (SCH Annual Report 2002).

subsidiary[10] and SCH sold its Peruvian subsidiary and 25 percent of its Mexican subsidiary's shares. Note however, that at the same time BBVA increased its participation in Mexico. In Eastern Europe most foreign presence come from European Union countries, with banks from Austria taking important positions in several countries.

Decisions taken by foreign banks can also impinge wider economic damage on host country economies, specially if foreign bank ownership is highly concentrated. Strategic decisions of the parent banks may have serious effects in emerging market economies. For example, in Bolivia a tightening of credit policies initiated by the banking subsidiary of Spanish Santander, and quickly followed by other foreign subsidiaries, worsened an already sluggish economy. Santander's Bolivian subsidiary Banco Santa Cruz[11] embarked in a restructuring of its balance sheet, with a dramatic reduction of credit.[12] In December 2002 it was the fifth largest bank in the country, in terms of credit granted, when it used to be the largest. Between December 1999 and December 2002 the credit portfolio of foreign banks declined by 62 percent, while the credit of the domestic private banking sector contracted by 9 percent (Chart 2).

Chart 2 Bolivia: Private Banking

Total Claims

Million dollars	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Change (%) Dec99 / Dec02
Domestic-owned banks								
Banco Nacional de Bolivia	363	410	474	481	433	400	406	-16%
Banco de la Unión S.A.	n.a.	n.a.	n.a.	n.a.	383	272	238	
Banco Mercantil	284	331	424	437	415	380	358	-18%
Banco Ganadero	42	83	140	162	159	142	127	-21%
Banco BISA	341	408	456	537	555	475	406	-24%
Banco Económico	148	216	268	262	231	191	173	-34%
Banco Solidario	47	62	71	78	72	74	75	-3%
SUM	**1,225**	**1,510**	**1,834**	**1,956**	**2,248**	**1,933**	**1,784**	**-9%**
Foreign-owned banks								
Banco Santa Cruz[1]	617	707	947	871	515	332	238	-73%
Banco de Crédito de Bolivia[2]	194	272	456	485	476	362	273	-44%
Banco de la Nación Argentina	20	31	32	25	22	17	10	-59%
Citibank N.A.	41	39	227	200	155	116	86	-57%
Banco do Brasil	4	8	10	12	14	12	6	-52%
SUM	**876**	**1,057**	**1,672**	**1,593**	**1,181**	**840**	**613**	**-62%**
ALL BANKS	**2,101**	**2,567**	**3,506**	**3,548**	**3,429**	**2,773**	**2,397**	**-32%**

[1] Banco Central Hispano (BCH, Spain) acquired 90 percent of the bank in 1998. After the merger of Banco Santander and BCH in Spain, the share increased to 96 percent in October 2001

[2] Acquired by Banco de Crédito del Perú in November 1993.

Source: IMF Financial Statistics, Bloomberg and National Publications.

[10] More precisely, BBVA's subsidiary in Brazil merged with Bradesco, Brazil's largest private bank. BBVA acquired a stake in the new bank. This transaction reduced the exposure of BBVA to Brazil by a half approximately.

[11] Banco Santa Cruz was acquired by Banco Central Hispano from Spain in late 1998, when it was the largest bank in Bolivia.

[12] According to the Bolivian supervisory authority, decisions taken by Banco Santa Cruz responded to both, policies dictated by its head office, as well as to regulation applied by the home country authorities. For example, more stringent limits on single credit exposures (Superintendencia de Bancos y Entidades Financieras de Bolivia (2002)).

1.3 Cherry picking and credit to small and medium size enterprises.

Small and medium sized firms (SMEs) play a major role in emerging markets economies (and also in developed countries) as they represent around 90 percent of the total firms population and generate a large share of employment (more than 50 percent in many countries) and value added in the economy. These firms are also significant sources of innovation. Access to credit is crucial for small business survival, and a key supplier of credit to SMEs is the commercial banking system. Banks may play an even greater role in emerging market economies in which they are the main financial intermediaries.

The widely held view is that foreign banks generate positive effects for the host countries in which they establish a local presence. However, several authors have stressed the possibility of higher financing constraints for small and medium size enterprises as foreign banks may serve only large and transparent customers (Berger et al (2001), Clarke et al (2002)). Overall, the majority of studies on the relationship between small business financing and bank credit have focused on the share of banks' credit portfolio assigned to such firms. The evidence suggests that large banks tend to assign a smaller share of their portfolio to SMEs (Peek and Rosengren (1998), Strahan and Weston (1998)).

Perhaps one of the most complete studies in terms of the number of countries analyzed was done by Clarke et al (2002), who used survey data of more than 4,000 firms operating in 36 countries. The authors found that foreign bank participation decreased the financing constraints (as perceived by firms' managers) of all firms in the economy. Although they also reported evidence which suggests that entry by foreign banks benefits large enterprises more than small enterprises, they did not find indications of any harm to SME finance. It is worth mentioning that even if foreign banks enter the domestic market in order to serve large corporate customers, increased competition in the wholesale market may force domestic banks to channel resources to SMEs while they begin the process of selecting among them the most creditworthy clients.[13]

Recent empirical findings for Mexico did not support the hypothesis that foreign banks tend to serve only large enterprises, however the results should be interpreted cautiously as smaller firms appear to have problems obtaining credit from foreign commercial banks (Cárdenas (2003)). Moreover, taking a closer look at the operations of small foreign banks operating in Mexico, there is evidence on the narrow scope of their credit operations. [14] These banks provide funding only to a rather limited number of customers, which cannot be categorized as large firms but with a higher than average amount of loans. Small foreign

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[13] According to a survey on lending practices to SMEs, international banks and banks specialised in foreign trade or in mortgage finance were not interested in the market for micro and small firms loans. The banks reported that high administrative costs and lack of network and personnel to serve the markets were strong deterrents to engage in such business. However, for the banks that were engaged, the most important factors were the profitability and changing market conditions. Many domestic banks lost their large clients to the international foreign banks hence, they began to look for new creditworthy clients from small and medium sized enterprises (Jenkins (2000)).

[14] Banks with a market share, based on total assets, not greater than 1.5 percent were classified as small.

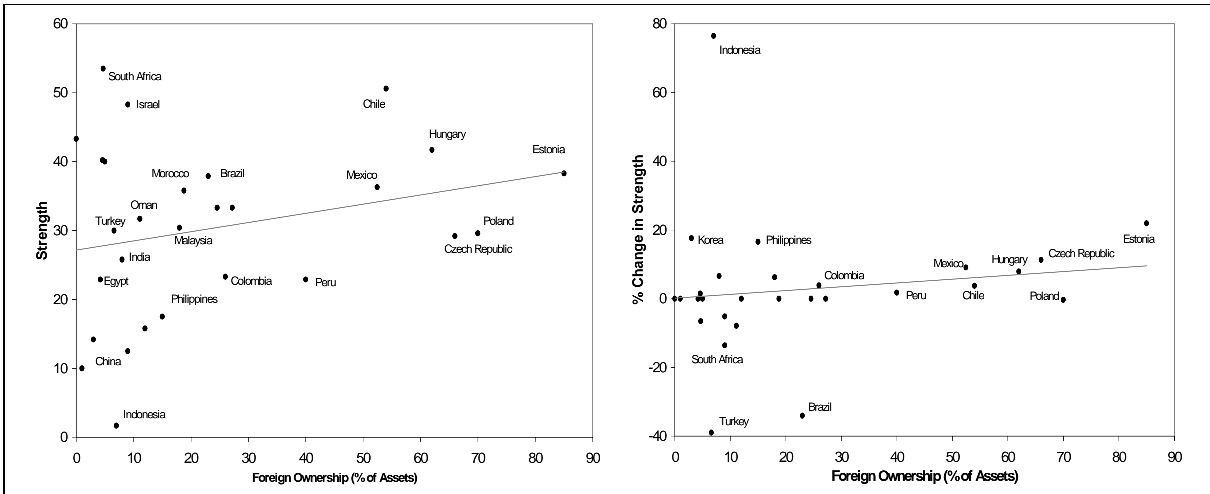
banks, if at all, attend the higher end of medium sized enterprises as it was also reflected by lower values of calculated scores measuring "bank's friendliness to SMEs".[15]

2.- Impact of FDI in the soundness of local entities.

In order to foster financial stability and protect small unsophisticated depositors governments around the world have established safety nets. However, safety nets increase both, moral hazard and the likelihood that a government could end up having to use public funds to rescue small depositors. Thus, authorities and supervisors concentrate on the soundness and prudent behavior of their locally incorporated financial institutions whose failure could damage their economies and deplete the resources of their safety nets.

During the last decade many emerging market economies have eliminated barriers to FDI, to obtain enough resources to replenish their financial institutions capital base after financial turmoil or to be able to privatize them. This section revises, from the perspective of a host country, the implications for the soundness of local entities when they are taken over by foreign investors. The positive and negative impacts from changes in business strategies and risk management policies introduced by new foreign owners, as well as the role played by different home country regulations and time-inconsistent policies regarding safety nets.

Graph 1 Moody's Weighted Average Financial Strength Index and Foreign Banks participation[1]



[1] Constructed according to a numerical scale assigned to Moody's weighted (by assets) average bank ratings by country. Zero indicates the lowest possible average rating and 100 indicates the highest possible average rating. Changes in strength (right hand side panel) show the percentage change in average ratings between December 2001 and May 2003. Financial Strength Ratings measure the bank's stand alone financial strength without reference to either sovereign transfer risk or implicit or explicit support from third parties.
Sources: Moody's, IMF Global Financial Stability Report (September 2003), Barth et al (2001), Hawkins and Mihaljek (2001) and National Central Banks.

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[15] The score of "bank friendliness to SMEs" was calculated following the methodology of the Small Business Administration (2001) from the US. The scores are based on the number and the amount of credits granted to SMEs by each bank.

Foreign investors not only bring new capital, novel technologies and management expertise to host countries. They also increase the local markets' resilience to withstand shocks, as they are perceived as a source of strength for local markets. International rating agencies take these facts into consideration as they tend to upgrade banks after they have been acquired by foreign investors (see Graph 1). [16]

2.1. Assessing parent support.

Market perception of the strength of foreign banks' subsidiaries[17] might stem from the commonly held view that they offer greater protection to local depositors than a locally owned bank, since the former will be supported by its parent bank's capital. For example:

> "*If a subsidiary of a foreign financial institution fails, it is assumed that to maintain its reputation the parent bank will assure the solvency of the subsidiary. In the case of branches or agencies, it has the legal obligation to do so […]*" (Makler and Ness (2002), p. 840.) [18]

Although there are some examples to support this statement, this is not always necessarily the case. In Hungary, for example, when the brokerage subsidiaries of foreign banks suffered large losses in the aftermath of the Russian crisis, head offices quickly injected capital (IMF (2000)); more recently, ABN AMRO and KBC promised to make good any losses to clients arisen from an allegedly fraud at their Hungarian subsidiary K&H equities. The subsidiary will resume operations after recapitalization by its shareholders (The Economist, September 27 2003). However, Southern Behrad from Malaysia refused to support its subsidiary Banco Austral in Mozambique, and Scotiabank, Credit Agricole and Intesa-BCI decided not to recapitalize their Argentinean subsidiaries after measures taken by the local government.

Holding companies often provide "comfort letters" to assure creditors (or authorities) that they would assist their subsidiary in case of distress. However, the existence of financial agreements between parent companies and their subsidiaries should not be considered as a source of strength as their enforceability in times of stress is very often questioned. Some authors have provided examples in which such commitments prove to be weaker than commonly thought. According to them, the British High Court ruled that "comfort letters represent nothing more than a moral commitment" (Boot et al (1993), p. 1165).

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[16] For an investigation of changes in ratings of banking institutions in Latin America see Crystal et al (2001).

[17] When assessing parent support is important to distinguish between branches and subsidiaries. Branches are operating entities which do not have a separate legal status from that of their parent bank (Basle Concordat (1983)). Subsidiaries are entities incorporated under host country's local laws and thus technically and legally considered as a stand alone entities. Rates assigned by rating agencies apply to a given subsidiary or to the parent company and all its branches.

[18] In fact, Argentinean depositors filed a legal dispute in Spain against the Spanish bank BBVA in order to recover deposits booked in Argentina given that "[s]ome of the success of global banks in attracting deposits, Argentine depositors argue, derived precisely from the fact they marketed themselves as being 'safer' than local banks because they have the backing of the parent company" (Del Negro and Kay (2002), p. 10).

Thus, support from the parent bank to its subsidiaries should not be taken as granted and local regulators should be aware that a foreign investor's decision to support a subsidiary will be solely made taking into account the balance of future profits and expenses including their legal and reputation costs:

> "*Foreign ownership should […] not be seen as necessarily perpetual, as disinvestment – for example, as a result of a domestic crisis or a change in the commercial strategy of the owner – always remains a possibility, and indeed disinvestment in accession countries by a strategic foreign owner had already occurred*"(Thimann (2002), p. 10).

In order to limit reputation costs of abandoning a subsidiary, some internationally active banks pondered the convenience of using different brand names.[19] Other strategy to reduce reputation costs consist in selling subsidiaries at a low price or even paying investors to acquire them instead of letting them fail. Of course, reputation costs also depend on the specific environment in which decisions are taken. For example, policies followed by the Argentinean government, which effectively depleted banks' capital, significantly reduced the cost of abandoning subsidiaries under such circumstances. Private investors can always blame authorities in times of stress. However, difficulties limited to one or two institutions might be easily related to management actions, whereas it is easier to associate a full systemic crisis with government policies (or inaccurate supervision and monitoring). Other cases will be more difficult to analyze and to "assign" responsibilities.

Fitch-IBCA is the only agency to assign bank ratings intended to asses whether support will be provided to a bank or not.[20] Recently, Fitch revised its support rating methodology, in which ratings explicitly indicated the source of support (*i.e.* governments or shareholders)

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[19] At the moment, evidence is only anecdotic. Royal Bank of Scotland (the world fifth largest bank by market value) operates under 22 different brand names or banking names (e.g. National Westminster Bank, Coutts, Tesco, Citizens Financial, etc.). According to its chief executive officer: "Running these businesses separately and under different brand names allows you to be different things for different people." The different brands compete for customers "many of whom never know they're ultimately dealing with the same institution" (See "Royal Bank of Scotland makes a name for itself by keeping low profile" By Erik Portanger Staff Reporter of The Wall Street Journal, September 23 2003). In fact this strategy is not characteristic of the banking markets. For example after some problems in the media company America Online Time Warner (AOL Time Warner) the online division is seeking to delete its name from the firm's title (see "AOL Alone" in Business this week, The economist, August 14 2003). ABN AMRO launched its "rebranding campaign" in September 2003. The group will use the same logo all over the world combined with the former names of acquired banks (e.g. Banco Real in Brazil or LaSalle Bank in the US).
In Mexico we have seen several strategies: Banamex is still using its original name after acquisition by the American Citigroup while Bancomer and Inverlat changed its names to BBVA- Bancomer and Scotiabank Inverlat after acquisition by Spanish and Canadian institutions. HSBC is known for being embarked in an ambitious project to create a unified global brand under the same name and logo, and its subsidiary operated under its Mexican name (Bital) for more than a year.

[20] Although Standard & Poors and Moody's take into account "extraordinary factors" such as government guarantees, lender of last resort assistance for financial institutions or support from foreign parent banks when assigning ratings, a separate rating assessing external support for a given entity is not published (see Taillon (2001), DeStefano (2003) and Cunningham (1999)).

but not necessarily its likelihood. The new methodology assess the probability of support for a given bank without making explicit its source.[21] Although the new ratings will not permit national authorities to evaluate directly the support that will be provided by foreign banks to their overseas subsidiaries as assessed by Fitch, the exercise and discussion generated by the new rating approach should be fruitful. Overall, the decision to invest additional resources will depend on the legal restrictions or obligations to do so, and a careful balance of benefits and costs incurred by parent banks. This issue is of utmost interest not only for policy makers and national authorities but also for market participants in general.

Chart 3 shows changes in FITCH-IBCA's support assessments for Central and Eastern European and Mexican banks for which ratings were available before and after acquisition by foreign investors. According to the rating agency, all banks analyzed would receive support in case of financial distress (13 from private shareholders and five from authorities). FITCH also considered that five banks which, before being acquired by foreign banks, were more likely to receive support from the government, now would be supported first by their new owners. Finally, four institutions for which support was considered very unlikely would be supported today by private investors.[22] [23]

Chart 3. Foreign institutions likely to receive support in case of financial distress according to FITCH-IBCA.

(Central and Eastern Europe and Mexico)

Source of Support		Number of banks
Before	**After**	
Government	Government	4
Private	Private	5
Government	Private	5
No support	Private	4
	Total	18

Source: FITCH-IBCA Credit Disk database and Bankscope database.

2.2 Impact of home country regulations on host country entities.

Legislation remains the basis on which a country ensures the responsible behavior of firms -whether domestic or foreign owned- within its territory. Although geographic boundaries have been blurred, global markets and institutions are still subject to the various local laws and jurisdictions in which they operate.

[21] The new methodology was formally introduced in July 2003, and it also takes into account transfer risk. See "Fitch announces new support rating methodology" (16 April 2003).

[22] In other words, support prior to acquisition was not likely but after receiving foreign capital the institutions became "A bank or bank holding company which has institutional owners of sufficient reputation and possessing such resources that, in our opinion, support would be forthcoming, if necessary." (FITCH-IBCA (2001), p. 12).

[23] In seven cases, the stand alone rating was also upgraded.

Authorities and shareholders alike have tried to protect their own interests by imposing provisions such as ring fencing, preferential treatment for depositors or limited liability for banking institutions as well as restrictions to the operations and activities permitted to financial institutions. These provisions have an impact, not only on the institutions organizational structure and the playing field in host country's markets, but also on the soundness and resources available for the protection of domestic claimants. Moreover, authorities from various countries may have different responsibilities to investors, depositors, creditors or even to taxpayers. Local regulations may also hinder international cooperation. Actions taken without international coordination may reduce the value of global banks' assets during insolvency procedures and thus reduce overall efficiency and welfare.[24]

The existence of financial operations carried out across different jurisdictions generate incentives for regulatory arbitrage and ambiguity regarding appropriate laws and courts under which cross-border disputes and liquidation processes should be resolved. In words of the governor of the Reserve Bank of New Zealand:

> *"[A]ssets and liabilities can move quite readily, sometimes at the push of a button, between the branch and the rest of the bank. In fair weather, that is fine. But in times of crisis, the distinction between the branch and the rest of the bank, and the legal location of assets and liabilities, may well become very important indeed"* (Bollard (2003a)).

In the case of subsidiaries, its easier to define which jurisdiction applies since laws characterize a subsidiary as a locally incorporated entity with its own capital. However, this fact may dwindle the effectiveness of authorities' efforts to perform consolidated supervision as legal arrangements often prevent the consolidation of entities during insolvency procedures.[25]

2.2.1. The single and separate entity doctrine: branches of foreign banks.

Another issue to consider is that legal outcomes of insolvency procedures may differ by the approach taken by each country. Some countries follow a "*separate-entity"* doctrine and thus are able to place their depositors and creditors before those of other countries, despite of liquidation laws in the other jurisdiction. For example, Australia (Banking Act, Section 13) and the United States (Omnibus Budget Reconciliation Act (1993)) have enacted rules

[24] Although still far from reaching consensus or a unified framework for resolutions, regulators have become increasingly aware of the complexities involved in the operation of banks across different countries e.g., the Basel Committee on Banking Supervision was established in 1975 after the failure of the Herstatt Bank. More recently, several policy makers and international standard setting institutions around the world have been working on issues related to cross border insolvencies (see G10 (2002), G30 (1998) and BCBS (1992)). Member countries of the European Community agreed to apply a uniform insolvency framework for banks under the European Community Directive on the Reorganization and Winding-Up of Credit Institutions enacted in the year 2001.

[25] An excellent description of cross border aspects of insolvency is provided in G10 (2002).

in which home country depositors (or creditors) are senior claimants over depositors from branches located overseas (i.e. Second class depositors) during bankruptcy proceedings.[26] [27]

Other countries follow a "*single-entity*" doctrine and consider a bank and its foreign branches as a whole and give an equal treatment to all creditors wherever their domicile (IMF (1998) and BCBS (1992)). For example, the Canadian and American legislations allows the authorities to "separate" the branch from its parent company and use the assets in order to cover the liabilities under the host country regulations. Although Canadian and American laws grant the authorities the right to seize the assets of a branch of a bank that is being liquidated abroad, it is not clear what will happen when the home country regulator or a third party seeks to challenge such actions, especially in a country characterized by the single entity doctrine (e.g. U.K.) in which a branch cannot be separated from its parent bank.[28] [29]

It is also worth mentioning that the US regulations grant the authorities the right to manage the largest possible amount of assets during a liquidation process in order to protect their interests. In the case of an American chartered bank it will be liquidated as a single entity (BCBS (1992)), thus assets of the bank will be consolidated. During a liquidation of a foreign bank's branch, US authorities will collect all the assets of the foreign bank in their jurisdiction (e.g., subsidiaries of the parent bank), even when those assets do not belong to the branch; hence, more assets will be available to reimburse the claimants of an ailing foreign bank's branch.

As a result of past experiences, supervisors and shareholders have attempted to protect their local assets by placing limits on the resources or obligations which can be channeled from a home bank to a branch operating in a different country, or from a locally operating branch to its foreign parent. This practice is usually known as ring fencing. The classic court case arising from the Philippine international payment moratorium of 1983 clearly illustrates this issue. The Singapore subsidiary of one US bank had placed a dollar deposit with another US bank's branch in Manila. After the Philippine government imposed a moratorium on the repayment of such deposits, the depositor bank sued the other US bank

[26] In 1990, the BIS reported that there were some countries in which the authorities are legally allowed to give preferential treatment to certain debtors in the event of a bankruptcy (BIS (1990)).

[27] In particular, it is interesting to note the response of New Zealand's authorities to the issue of national depositor preference (in the home country), given that foreign banks control 16 out 18 banks operating in the country and almost 99 percent of banks' assets as of April 2002 (Hull (2002)). According to regulations enacted during the year 2001, the NZRB may require local incorporation (i.e. opening up as subsidiaries) of, among others, institutions that come from jurisdictions which give preference to home country depositors or where the level of public disclosure is inadequate (see RBNZ (2001) and RBNZ (1999)).

[28] In case that the assets of the bank were not enough to reimburse all creditors, they may seek repayment in other jurisdictions.

[29] It should be noted that in the Canadian case, in order for branches to be authorized to use the Large Value Transfer System (Canada's most important payments system), regulators will grant or deny authorization after hearing the opinion of the bank's home country authorities regarding the applicability and enforcement of Canadian rules.

in American courts for repayment in the United States. Eventually, it was clarified that in such a case the depositor bears the transfer risk, leaving the bank that accepts the deposit and lends it out locally to bear the balance of country risk. In this example, the first issue was to determine where to settle the dispute: in the Philippines or in the US? After the dispute was settled (in American courts), the US authorities enacted legislation making clear that the repayment of dollar denominated deposits of foreign branches of a US bank will be payable in the US only when explicitly stated in the contract, moreover banks may relinquish their obligation to support their foreign branches or repay their liabilities under special circumstances.[30]

Today, the ISDA Master Agreement includes "Ring-fencing Provisions" which provides that counterparties may not seek recourse to a head office in case that the branch is unable to fulfill its obligations as a consequence of events such as exchange controls or expropriation (ISDA (2003), Section10(a)). Even in cases in which foreign banks formally guarantee the operations of their branches or subsidiaries there are disclaimers specifying repayment only on a specified host country branch (a provision statutory for American banks) and in the currencies allowed by the host country government (Taillon (2001)).

2.2.2. Subsidiaries of foreign banks.

Although the separate or single entity doctrines applies specifically to branches, differences on the legal framework applying within each country will have effects also for subsidiaries. For example, the home country regulation applicable to a bank holding company affects the operations of its banking subsidiaries located abroad. In regards to the applicable jurisdiction and the particular characteristics of the U.S. regulatory scaffolding, it should be noted that American regulation may blur the boundaries among an affiliate and its parent company: Members of a financial group are obliged to rescue their failing peers. According to Hüpkes (2003, p. 31) "Under the source-of-strength principle in US law, a holding company must act as a source-of-strength to its subsidiary banks." [31] [32] Moreover, in the case of a bank failure "the FDIC is authorized to bill the cost of the failure to affiliate or sister banks" (Oshinsky (1999)). Under American laws a parent company is responsible for the operations of their subsidiaries when it can be proven that the subsidiary is not managed

[30] 936 F.2d 723; 1991 US App. The Supreme Court ultimately found in favour of the plaintiff, arguing that the deposit contract did not explicitly prevent the repayment in New York. US law was subsequently amended (Title 12, United States Code, section 633 (1994)) in effect to reverse this ruling so that, in the event of a moratorium, payment would be required in the United States only if the contract explicitly called for repayment in such circumstances (McCauley, Ruud and Wooldridge (2002), p. 50).

[31] "A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner." 12 C.F.R. § 225.4. Also "A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank, will generally be considered an unsafe and unsound banking practice…" Federal Deposit Insurance Corporation, 52 Fed. Reg. 15707, April 30, 1987.

[32] Swiss courts have also embraced the same principle (Hüpkes (2003)) and under Mexican law a financial holding company must support the operations of a failing bank by selling its stakes in other companies.

independently or that management was impaired by the strong interests of its parent.[33] In the case of global banks it is becoming a common practice to manage risks on a consolidated basis or to rely on the parent for the approval of significant credit transactions, in this sense, the legal and functional frontiers among members of a banking organization are increasingly hazy.

The final settlement or support that will be provided by parents (and affiliates or sister banks) is not clear at all. Greenspan (1998) mentioned some legal conflicts that may arise when banks or holding companies attempt to -or have to- support their subsidiaries:

> *"The Treasury, […], has proposed and supported new principal activities in the operating subsidiary. It argues that potential losses in the operating subsidiary could be capped in such a way as to eliminate the exposure of the safety net. […] Moreover, the bank would be prohibited from making good any of the debts of the failed subsidiary.*
>
> *[…] I should note that it is necessary that all of these prohibitions be statutory, since generally accepted accounting principles -GAAP- require that the subsidiaries' operations be consolidated with its parent and that courts determine if a parent is responsible for the claims on its failed subsidiaries."*

Home country regulation may also have adverse effects on local financial groups. In many countries, banks belong to financial holding companies which usually hold investments in non-bank businesses such as insurance, brokerage houses, mutual funds, non-bank banks and in occasions non-financial companies. When a subsidiary is in financial need, regulation often requires holding companies to dispose other investments to recapitalize their failing subsidiary. This regulation provides the financial group and its members with the advantage of enjoying the support of capital diversified in different business lines and grants the authorities the flexibility to call for further support for a bank.[34] However, some countries have restrictions on the type of business units that their banking holding companies can invest on, regardless whether such investments are done in the home country or abroad.

A holding group established in an EME and owned by a foreign bank may find itself forced to des-invest itself from some non-bank business lines like insurance. By des-investing itself, the local group looses business diversification and its bank potential support in case of trouble.[35] It is important to note, however, that divestment may also be the consequence of strategic or business decisions taken by the parent company.

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[33] This concept is known as the "corporate veil" or "alter ego" theory. Most common law countries (e.g. United States and the United Kingdom, recognize these concepts (Dawson (1998)).

[34] In order to reap the full benefits of diversification, regulation should properly insulate the different business lines to avoid conflicts of interest and extension of the safety net.

[35] When Citibank acquired the Mexican financial group which owns Banamex, it was forced to des-invest from an American bank established in California and from other non-financial business to comply with American regulation. Hence the pool of assets directly available to support the bank was reduced.

2.3 Impact of parent banks' business strategies on host country entities

As markets and institutions become global, business decisions increasingly disregard country boundaries. Business strategies, accounting and risk measurement are done on a consolidated basis and economic transactions are booked where regulation is less costly. Although, this global approach makes sense from the point of view of the parent firm, it may cause undesired effects on its foreign subsidiaries, which are still subject to the laws and risks of the country where they are incorporated.

2.3.1. Risk management policies

Global financial firms are increasingly concentrating their business units and managerial decision levels in fewer places. In the case of risk management policies, financial institutions are measuring their exposure to different risk factors on a global basis, consolidating all their positions, disregarding where these positions are booked. There is ample evidence that this shift takes place soon after banks in EME are taken over by foreign banks. In Poland,

> *"…part of the subsidiaries have already been operating like branches, focusing above all on sales, with decision-making powers being locally limited and part of risk management being located abroad"* (Bednarski and Osinski (2002), p. 185). In Hungary, *"…a number of these* [foreign] *banks are already operating like branches, which is perceptible in many areas ranging from decision-making mechanisms to risk management activities"* (Zsámboki (2002), p. 114).

At the same time, global institutions are increasingly booking certain types of positions, like derivatives, in "hubs", to take advantage of economies of scale and friendlier regulatory environments, as well as to exert better control:

> "*Some of the foreign banks with subsidiaries in Poland moved part of risk management and more sophisticated products to London*" (Bednarski and Osinski (2002), p. 186).

These policies mean, for example, that a long position on a fix-rate-10-year-bond denominated in pesos booked in a Mexican subsidiary, might be hedged with a derivative position booked in a Cayman Island branch. Thus, losses incurred by one subsidiary will be offset by gains on the other. While this policy might be optimal from a parent bank perspective, local subsidiaries are left to experience wide fluctuations in their profit-loss statements. Furthermore there are no obligations, neither guarantees, that the parent will use gains in one entity to cover losses in another.

The management policies are also looking to consolidate all credit country risks in the country where they are originated. Positions on Mexican credit risks are taken in Mexican subsidiaries and Brazilian credit risks on Sao Paulo branches. Following these policies, subsidiaries established in host countries have been des-investing from foreign credit risks by selling all bonds, stocks or credits not issued in the same country where they are

incorporated. Local subsidiaries loose any potential advantage from holding a more geographical diversified portfolio.[36]

Imported risk management techniques and policies have also improved the conditions of banks operating in emerging market economies as foreign institutions bring new technologies and oblige their subsidiaries to comply with international standards.

2.3.2. Loss of alternative sources of funding

Bank's located in emerging market economies, very often use their branches and subsidiaries in major financial centers (New York, London, etc.) as foreign currency funding windows. They use them to issue foreign debt or to attract deposits from wealthy citizens who do not want to be exposed to the risk of having their savings forcefully converted into their domestic currency (e.g. Mexico 1982, Croatia 1991, Argentina 2002). After an international bank acquires a bank in an emerging country, it usually closes its foreign funding windows to eliminate duplicity of operations. In Mexico, for example, the seven largest banks have closed 14 subsidiaries abroad, many of them used as funding windows, after being acquired by foreign banks (CNBV Statistical Bulletin 1994-2002).

These business decisions aim to reduce operational costs and also respond to the need of excerpting more control over money laundering activities. However, they make the subsidiary more dependent on the willingness of its parent bank to provide funding during times of stress. Moreover, subsidiaries would be competing for funds among themselves, as the parent company has the sole power to direct its resources anywhere.

This relationship of parent-subsidiary could lessen the overall stability of the host financial system when headquarters decide to close or limit the funding channel to some particular subsidiaries. Thus, a concern for EME financial authorities regarding foreign bank entry, is the operational dependency of its foreign owned banks to the willingness of the foreign shareholder to fund its activities. In general, subsidiaries will enjoy a larger and cheaper access to foreign funding. However, it is not clear that in times of trouble the parent bank will keep the funding channel open. In such a case, the lack of international diversification of assets will leave the local subsidiary on a weaker position and without access to international funding.[37] The above situation could be even more troublesome when banking ownership is highly concentrated in a single foreign country. Adverse shocks to that foreign country could easily spill-over and engulf the host country economy as access to different or additional sources of funding becomes very limited.

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[36] Risk management decisions might also be influenced by regulations and the institutional framework in different countries. Examples: deposit taking will be influenced by deposit insurance costs and booking of loans by capital charges.

[37] However, it is important to recognize that during times of stress domestically owned institutions will also find difficult to tap international markets.

2.3.3 Corporate governance in subsidiaries.

Global institutions seek to maximize their benefits by managing their investments on a portfolio basis. Accordingly, the allocation of resources is made following an assessment of risk/return conditions at their various subsidiaries. Thus, some subsidiaries might face changes in strategy or even loose business lines, while others obtain more resources. These decisions are made always aimed at benefiting the stockholders of the controlling institution. However, some strategies could at the same time jeopardize the ability of some subsidiaries to generate value. A concern may arise when those decisions affect the interests of other stakeholders of the subsidiary, |such as depositors and authorities managing the safety net.[38] For this reason, the governance structures of the subsidiaries should be adequately designed to reflect the interests of both the parent company and the stakeholders of the subsidiary. [39]

The Basel Committee on Banking Supervision (BCBS (1999)) issued guidelines on corporate governance for banks. According to these, among the responsibilities of the board of directors and senior management are to decide the way in which banks:

- Set corporate objectives (including generating economic returns to owners).
- Run the day-to-day operations of the business.
- Consider the interests of recognized stakeholders (which include employees, customers, suppliers and even authorities.)[40]
- Align corporate activities and behavior with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations.
- Protect the interests of depositors.

The importance of board and management looking after the interests of all the stakeholders of the financial institutions is clearly established in the New Zealand regulation. According to the companies act in New Zealand, directors should act in the best interests of the company.[41] However, a director of a subsidiary may, if permitted to do so by the constitution of the subsidiary, act in the best interests of the holding company even when it may not be in the best interests of the subsidiary. New Zealand authorities require banks to have constitutions that explicitly prevent directors from damaging the subsidiary and its creditors while pursuing benefits for the holding company (RBNZ (2003)). [42]

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[38] According to agency theory the different incentives faced by individuals (or stakeholders) generate costs in order to align all the actions of the agents towards a common goal. For a formal treatment of this subjects see Jensen and Meckling (1976). Moreover, the parent company might be liable for the operations of its subsidiaries. For example, under American laws, if it can be proven that the management of a subsidiary was not separated from the management of the parent company or that the former acted in the interest of the latter the parent will be responsible for the operations (and debts) of the failing subsidiary.

[39] Some countries have already recognized the subject and have enacted regulation to deal with it. For example,

[40] As a consequence of the importance of banks on economic development and the existence of the safety net, government authorities and supervisors are also stakeholders of banking institutions.

[41] Article 131, Companies Act.

[42] In October 2003, the Reserve Bank of New Zealand authorized the purchase of Lloyd's National Bank of New Zealand by the Australian ANZ Banking group. The operation was approved by authorities subject to conditions "aimed at ensuring that local boards have effective operational reach over core assets and people, and the lines of responsibility and accountability are clear" (Bollard (2003b)). Some conditions for the

Independent board members may play an important role in protecting the interests of all stakeholders. This is recognized by the OECD Principles of Corporate Governance (OECD (1999)) which assign a prominent role for independent board members in situations in which the interests of management, the company and shareholders may diverge. The role of independent directors is more important when ownership is highly concentrated as it is the case with subsidiaries. Regulators in Australia and New Zealand, among others, have shown particular concerns regarding the management of subsidiaries of foreign banks. Accordingly, they have implemented different measures to strengthen governance in these institutions. Banks must include independent directors[43] on their boards in order to make sure that management acts in the best interest of the local institution. In words of a former Governor of the Reserve Bank of Australia addressing the Overseas Banker's Association:

> *"[…] an Australian subsidiary is a separate bank in its own right, and not a branch of the overseas parent. The policy of the subsidiary will necessarily be set by the overseas parent, but it is reasonable that there be some independent minds on the board prepared to speak up, should it be necessary, for the interests of the local depositors. While the independent directors will usually be in the minority and can be outvoted, in extreme cases they may well take more radical steps, such as resigning and explaining their positions to the central bank. I see nothing wrong in that situation"* (Fraser(1994), p. 22).

2.4. Time-inconsistent safety net policies: ownership matters.

As it was already mentioned, the correct functioning of the financial system is of utmost importance for authorities. In order to protect small depositors and to foster systemic stability governments create safety nets for financial institutions that, unfortunately, also generate moral hazard in the industry.

In an attempt to limit moral hazard, authorities setup a complex regulatory scaffolding in which deposit insurance and banking supervision play a crucial role. It seems that there is a trend towards explicit and limited coverage of depositors (García (1999)). Although that may work during normal times, agents recognize that during times of stress the authorities may not be able (or willing) to follow their own rules and, in order to diminish the risks of a systemic crisis, they might bail out some institutions usually perceived as "too big to fail" (TBTF). Such institutions are present not only in the financial sector, and often governments end up bailing out enterprises whose failure is considered too damaging for the economy, to a particular sector or to national security. It is in this sense that a limited coverage of depositors and a strict "no support" policy, may be time inconsistent for the

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acquisition were imposed: a) Migration of business and outsourcing of National Bank's core functionality must be approved by the RBNZ. This action aimed to guarantee that the bank may be able to operate on a stand alone basis. b)The appointments of directors or senior executives must be approved by the RBNZ. Furthermore the Chief Executive Officer must be contracted directly by the board of the National Bank of New Zealand and any amendments to the constitution of the bank should also be approved by the authorities.

[43] Boards should include at least two independent members. An independent member should not be an employee of the bank nor a director or employee of any holding company of the bank or of any other entity able to control or significantly influence the bank located in the host country.

authorities (i.e. in times of stress they will change their chosen optimal plan –no support- in light of current developments or externalities that a distressed institution may generate).[44] However, when a foreign investor takes over an enterprise which could be considered strategic, the TBTF dilemma might work the other way. Political pressure may preclude authorities to support a falling foreign institution and in this sense policy actions may become time consistent. Host country governments not only will be reluctant to bail out subsidiaries of foreign banks, but also more prone to pressure their stockholders to invest new funds to recapitalize them, specially if the troubled institution plays an important role in such country.

The airlines industry constitutes a good example of the latter. When Sabena and Aerolíneas Argentinas were experiencing financial difficulties, political pressure on their respective countries mounted against using public funds to support them. Instead, local governments exerted pressure on stockholders from Swiss Air and Spaniard Iberia to commit new funds. In some respect the TBTF argument, which might sometimes benefit shareholders, worked the other way around.

3. Market discipline

There is a general consensus regarding the growing role played by market discipline in helping supervisory authorities fulfill their obligations. On one hand, market discipline creates incentives for publicly traded companies to seek prudent behavior. On the other, the mechanisms implemented to facilitate the workings of market discipline, like more timely and strict processes for the disclosure of financial data, provide supervisory authorities with more reliable information regarding market perceptions of the soundness and profitability of their supervisees (share's prices, debts spreads, credit ratings). There is an agreement that government supervision and regulation, without external market pressures, are bound to fail, and that market discipline oriented policies must contain features that entice markets to provide the right signals and exert the appropriate penalties.

3.1 De-listing

The Basel Committee has recognized the potential of market discipline to reinforce capital regulation and other supervisory efforts. In this respect, the Committee is proposing several disclosure requirements which will allow market participants (i.e. investors, un-protected depositors, other creditors, credit rating agencies) to discipline financial institutions. However, countries will not reap the full benefits of the proposed third pillar when financial institutions are not listed or when they become de-listed as a result of their acquisition by a foreign stockholder. Equity de-listing deprives the market of information with respect to the firm. In the financial sector the loss of information is particularly troublesome as institutions are highly leveraged. The lack of information affects large sophisticated investors and governments that protect small unsophisticated depositors.

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[44] Some countries have enacted rules in which deposit insurance authorities must follow the "least cost resolution" (LCR) strategy when resolving a bank (e.g. protecting only insured depositors). However, regulation allows authorities in some cases (such as the United States, Japan, Spain and Argentina) to deviate from the LCR strategy by invoking a "systemic risk exception."

However, requiring financial institutions to increase information disclosure will not lead by itself to a more stringent enforcement of market discipline. [45] The lack of market-traded instruments will preclude the existence of market signals as well as the scrutiny of independent bank analysts, which usually participate in shareholder's briefings and stockholders assemblies to obtain information regarding the listed financial institution's weaknesses, strengths and future plans.

Even though acquiring institutions are listed in their home markets or even in host country markets, the information related to such equity is not relevant to assess the soundness of subsidiaries unless they represent a significant share of the holding firm's total assets, which is rarely the case.

The problem is not limited to information disclosure. Perhaps more important is the disappearance of independent bank analysts who disentangle and interpret otherwise not-easy-to-understand financial information. Furthermore, financial statements seldom tell all about a company. This is why analysts do not restrain themselves to just interpret public information, they also talk to as many people as possible within a firm.[46] In addition to the information that is lost directly when banks' equity is no longer traded, signals –conveyed by prices – reflecting market perceptions will be lost.

Finally, by de-listing the equity of an important proportion of the banks operating within a country, capital markets – which may already be underdeveloped – could be seriously affected in depth and, therefore, in liquidity, becoming less attractive to investors. In Estonia, the largest banking corporation (Hansapank) remains listed in the local stock exchange since its strategic foreign owner (Swedbank) decided to acquire only 60 percent of the shares and left the remaining shares floating. This was considered crucial for the sound development of the local stock market (Thiman et al (2002)).

The problems associated with de-listings described before have probably led authorities in some countries to persuade foreign banks to keep the shares of acquired institutions listed. This is specially the case in Poland:

> *"Another aspect of the foreign control of the major banks in Poland relates to the policy of the Government, which decided that major foreign-owned banks (formerly Polish ones) should be quoted on the Warsaw Stock Exchange (WSE). In consequence, part of the equity in these banks is dispersed among smaller Polish investors. Also, the rigorous reporting requirements for listed companies, banks included, enhance the transparency of their finances. As a result of this Government policy, almost all the major banks operating in Poland, especially the foreign-owned ones, are quoted on the WSE, and these account for a substantial portion of market capitalization – close to 30%. However, the free float of these banks is on average no greater than 15-25%."* (Bednarski and Osinski (2002), p. 176).

[45] For instance, the supervisory Commission in Mexico has issued regulation requiring all banks, listed or not in the stock market, to disclose large amounts of financial information.
[46] An analyst from Credit Suisse First Boston expressed his concerns regarding these problems by saying that "important banks, after de-listed, have not provided any information at all to analysts and investors. Mexican Banamex is the perfect example, after being acquired by Citibank it does not provide any quarterly press releases and does not receive any investors or analysts for meetings anymore."

3.2. Accounting standards

The economic and financial crises in emerging market countries as well as recent bankruptcy cases in the United States, underlined the need for more reliable and transparent accounting and financial reporting. However, parent banks and their foreign subsidiaries are very often subject to different accounting standards, which can lead to discrepant financial balances, even when they are based on the same financial information. This fact makes comparisons between international financial statements extremely cumbersome and challenges the reliability of banks financial statements. As an example, chart 4 compares financial information disclosed by Citibank in the USA regarding its Mexican subsidiary Banamex with the information disclosed by Banamex in Mexico. There are several reasons that explain the sharp difference between both sources which stood at around one billion dollars for the year 2002. Discrepancies arise from different tax treatment, deferred taxes, valuation and accounting of repos, amortization of goodwill, treatment of past due loans and from provision and inflationary accounting adjustments.

Chart 4. Banamex's earnings in 2002
(millions of Mexican pesos)

	1st Q	2nd Q	3rd Q	4th Q	2002
Mexico	1,494	784	103	(2,492)	(110)
USA	2,046	1,730	2,772	3,649	10,197

This experience is not and isolated event. Citibank's Brazilian subsidiary reported a net loss of 220.5 million reals (73.8 million usd) for the first six months of 2003, but according to Citigroup the loss was "just a technicality under Brazilian generally accepted accounting principles" and it was "offset in the financial-service company's consolidated results."[47] According to a financial analyst working for Bear Stearns in New York, "Citigroup doesn't break out figures for Brazil in its U.S. financial statements. The difficulty is that Citi doesn't give enough information to reconcile what it reports in local markets and what it reports on a consolidated basis for Latin America. The latest consolidated results show that Citigroup performed relatively well in Brazil."[48]

The implications of diverging accounting standards are receiving increasing attention by regulators worldwide. The Basel Committee organized a workshop to discuss issues related to different accounting rules, disclosure requirements and implication for bank stability.

[47] See "Citigroup in Brazil Had 1st-Half Loss" By Jonathan Karp Reporter of The Wall Street Journal, August 27 2003. "Fielding many investor queries Tuesday, Citigroup executives disputed that assertion and said that in consolidated results under U.S. GAAP, the bank didn't lose money on Brazil. Spokeswoman Lula Rodriguez said, The fundamental difference from U.S. GAAP is that local GAAP mandates that all capital-hedging costs be recorded through earnings, while the [gain/loss] on the investment which offset part of the losses does not appear in the local GAAP financials."

[48] Ibid.

Conclusions

Benefits of FDI in financial systems of emerging market economies (EME) stem from efficiency gains brought about by new technologies, products and management techniques as well as from increased competition stimulated by new entrants. The presence of foreign owned institutions might be a mitigating factor of negative effects of increased market concentration.

Although foreign banks can be seen as a source of stability during times or stress, they can also foster contagion. Furthermore, when ownership of a banking system is highly concentrated in a single foreign country the benefits of risk diversification might not be attained as an adverse shock to that foreign country could easily spill-over and engulf the host country economy. In some cases foreign banks have acquired important positions on a regional basis (e.g. Latin America or Central Europe). This also rises concerns that a crisis in a particular country may affect the other countries through investment decisions of these banks.

Foreign banks entry might also affect credit availability for small or opaque firms. Research suggest that although large firms might be the most benefited from foreign bank presence, small firms are not damaged in spite of business strategies of small/newly established foreign banks subsidiaries which attend mostly corporate customers.

Additional benefits arise from new capital brought by foreign investors, specially in countries severely hit by financial crises. In many cases the financial strength of banking institutions tends to be higher for foreign firms than for domestic entities. However support from parent companies should not be taken for granted as the decision to commit more resources will be solely made taking into account the balance of future profits and expenses including legal and reputation costs. Furthermore, support and resources available to host country depositors (and creditors) may decrease depending on the particular jurisdiction and the organizational structure in which global banks operate (e.g. second class depositors, ring fencing provisions, source of strength principle, branches or subsidiaries, etc.).

Imported risk management practices have also improved conditions of banks operating in EME. Domestic banks are drastically transformed after being taken over by a global bank. Parent companies have instructed their subsidiaries to reduce exposures to foreign countries and to close their branches and subsidiaries located abroad. In "normal" times this strategy makes sense from a global perspective, but during times of stress, this policy may leave the subsidiary in a less diversified position. At the same time, managing risk on a global basis brings large benefits for internationally active banks. However, there are no obligations, nor guarantees, that the parent bank will use gains obtained in any given subsidiary to cover losses incurred by another subsidiary when hedging a position of the global bank. Furthermore, management of the host country institution should have adequate incentives in order to pursue the best interests of the local establishment as in some cases actions to improve benefits for the parent company may weaken the subsidiary.

Foreign institutions foster development of national financial systems by bringing in new products and know how. However they may also negatively affect local markets by de-

listing acquired financial institutions. When companies are no longer publicly traded, market discipline might be hindered by the loss of available information and by the lack of analyst disentangling information provided by banks. Authorities must make sure that this process does not lead to less transparency and alternative mechanisms should be found for the market to be able to discipline banks. Efforts should also be made by all countries in order to converge faster to international accounting standards as local differences make comparisons between financial statements in different countries extremely cumbersome thus challenging the reliability of financial information disclosed.

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