



Foreign Banks Entry in Emerging Market Economies: A Host Country Perspective

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***The views expressed are the author's
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Cross-border banking

Changes in cross-border banking:

- Mitigation of transfer and exchange-rate risks
- Advances in IT
- Portfolio diversification
- Desire to tap the profitable household sector
- Replication of business lines and products
- Economies of scale
- Prevention of unfriendly takeovers through gain in size

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Cross-border banking

Changes in the way of doing cross-border banking:

- Cross-border lending through representative offices.
- Establishment of subsidiaries to enter retail banking.
- Funding on international markets increasingly taking place.
- Most acquirer banks are based in developed economies.
- In recent years, banks from EM are taking positions mainly in other developing countries.
- Acquirers' size shifted from LCFIs to smaller, less complex entities.

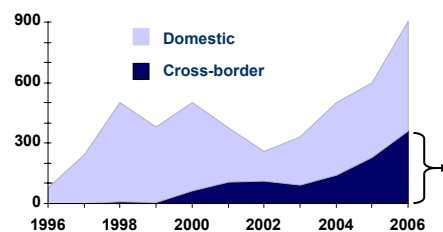
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Cross-border M&A's

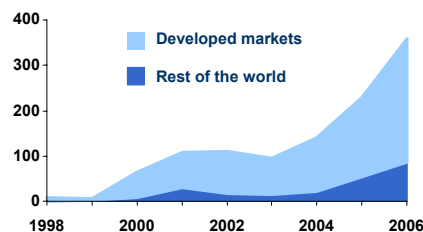
Financial institutions are expanding overseas increasingly.

- Cross-border M&A operations grew rapidly in the last 10 years.
 - Non-developed markets are quickly gaining a greater share of total transactions by target origin.

Financial industry M&A operations
(US\$, billions)



Cross-border M&A by target origin
(US\$, billions)



Source: IMF, Global Financial Stability Report

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Cross-border banking

- In developing countries, investment has been prompted by:
 - Recapitalization of banks after financial crises (LatAm, East Asia).
 - Privatization of state-owned banks (Eastern Europe, China).

Region	Foreign banks (% of Assets)	
	1995	2005
All countries (105)	15	23
North America (2)	10	21
Western Europe (19)	23	29
Eastern Europe (8)	25	58
Latin America (14)	18	38
Africa (25)	8	8
Middle East (9)	14	17
Central Asia (4)	2	2
East Asia & Oceania (13)	5	6

Source: IMF, Global Financial Stability Report

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Motivations: Portfolio diversification

Banks based in:	Percentage of activities in:		
	Home Country	Rest of the region	Rest of the world
North America (20 banks)	77	8	15
Europe (50 banks)	55	24	21
Asia and Pacific (20 banks)	86	5	9

Source: IMF, Global Financial Stability Report

Bank's net profit structure by region (percentages)

	Home	Europe	Asia	North Am.	Lat. Am.	Other	TOTAL
HSBC	22	10	39	21	8		100
BBVA	32			1	47	20	100
Santander	31	27			34	8	100
Scotiabank	60			3	13	23	100
Citigroup	54		17		13	16	100

Source: Annual reports, December 2006.

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Motivations: Desire to tap the household sector

Immigrants, mainly Hispanic, remain largely unbanked in the U.S.*

- **U.S. households without transaction accounts:**
 - **18% of U.S.-born**
 - **32% of foreign-born**
 - **54% of Mexican immigrants**
- **Home ownership:**
 - **70% for U.S.-born**
 - **41% for Latin American immigrants**

* 1999 US Census Survey on Income and Program Participation.

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Motivations: Economies of scale and scope

Through M&A's and other alliances, a number of banks in Mexico are in a position to serve the U.S. remittances market.

- 54% of Hispanics living in the U.S. regularly send money abroad; 65% of them use money transfer services.
- Families receiving remittances are usually unbanked as well.

BBVA, acquired Compass Bancshares and others in the Sun Belt.

Bank of America acquired 24.9% of Santander Serfin.

Santander acquired 25% of Sovereign Bancorp.

Banorte acquired 70% of Inter National Bank.

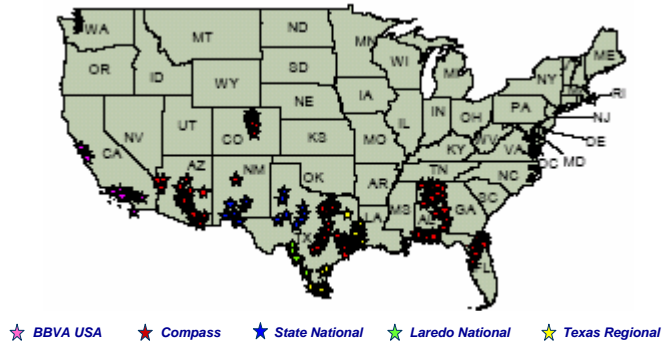
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Motivations: Replication of business lines and products

BBVA's expertise on serving immigrants in Spain ("Dinero Express" and "Duo" model).

It has acquired: Compass, Texas Regional, Laredo National & State National.



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Benefits from the entry of foreign banks

- Efficiency gains
- New technology
- Innovation in products and services
- Improved risk management
- Strengthened capital
- Decrease in related lending

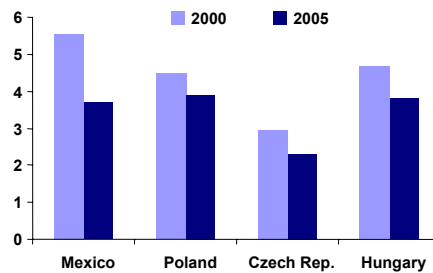
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Benefits from the entry of foreign banks

- Efficiency gains

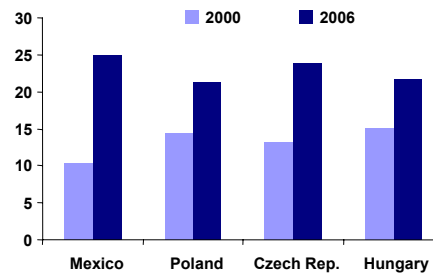
Operating Expenses
(as a percentage of total assets)



Source: Bankscope

ROE

(Profits after taxes as a percentage of equity)



Source: IMF, Global Financial Stability Report

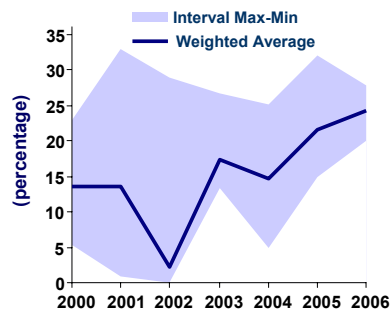
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Benefits from the entry of foreign banks

- Efficiency gains

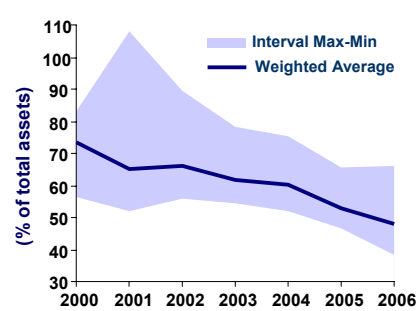
Mexican banks (6 largest)

ROE



Source: Banco de Mexico

Efficiency index



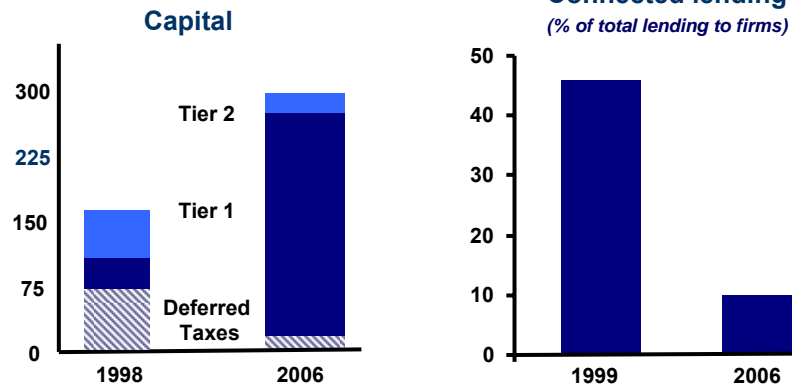
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Benefits from the entry of foreign banks

- Strengthened capital
- Decrease in related lending

Mexican banks



Source: CNBV.

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Ability to stand alone

Branches:

Do not have a separate legal status from that of their parent banks (Basle Concordat, 1983).

Subsidiaries:

Entities incorporated under host country's local laws.

They are technically and legally considered as stand-alone entities.

Legal responsibilities of parent bank are limited to invested capital.

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Operation of global banks

Maximization of risk-adjusted returns on a global-portfolio basis:

- Centralization of strategic business decisions and risk management
- Separation along business lines and matrix reporting arrangements
- Benefits from regulatory differences and economies of scale
- Outsourcing of key operations
- Consolidation of financial statements at parent level

The degree of centralization depends on:

- Relative size of entities
- Subsidiary ownership structure
- Particular organizational arrangements

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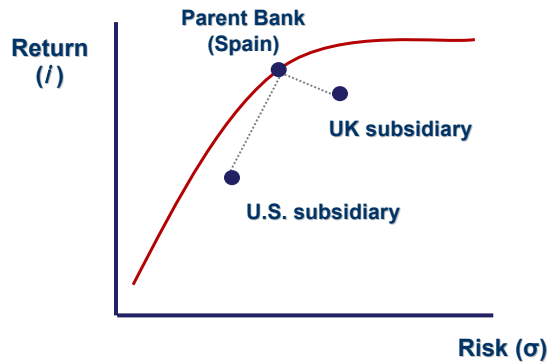


Challenges for local authorities

1. Ability to stand alone
2. Impact on host-country markets
3. Cross-border crisis management

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Ability to stand alone



Maximize risk-adjusted returns on a portfolio basis

Global banks have access to more investment opportunities than local banks.

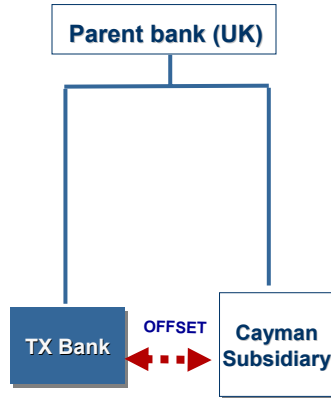
They allocate their business lines and capital to maximize their global risk-adjusted returns.

Parent bank decisions to allocate business may diverge from subsidiaries' self-interest.

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Ability to stand alone

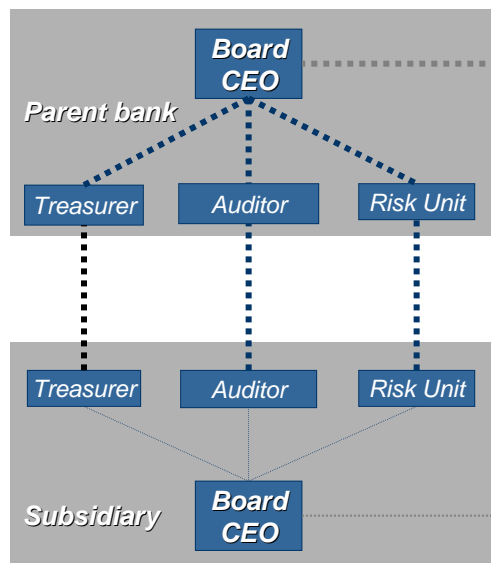


Benefits from regulatory differences and economies of scale

Parent banks measure exposure on a global basis by consolidating all their positions regardless of where they are booked.

Subsidiaries could end up with sub-optimal risk-return allocations from their own (stand-alone) point of view.

Ability to stand alone



Global banks divide their products and services along business lines.

Matrix reporting arrangements

Some subsidiaries are managed as branches



Ability to stand alone: Solvency

It is often thought that when a subsidiary of a foreign financial institution fails, to maintain its reputation, the parent bank will assure the solvency of the subsidiary. In the case of branches, it has the legal obligation to do so.

However, a foreign bank's decision to support a subsidiary will be made taking into account the balance of future profits and expenses, including legal and reputation costs.

Host financial authorities cannot rely on the assumption that home parent banks will always provide support.

Compliance with capital rules is not enough. Profitability and business viability are very important.

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Ability to stand alone

"The formal legal distinctions and separation [between parent and subsidiary] are not matched by a similar economic separation"

Charles Goodhart

Parent banks and subsidiaries are different legal entities.

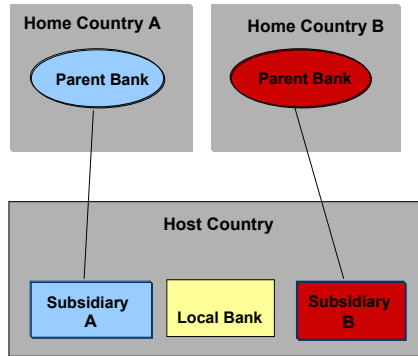
Subsidiaries are managed as branches, but legal responsibilities are limited to capital invested.

Uneven division of decision-making powers and responsibilities.

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Regulatory differences in home countries



Subsidiaries consolidate their financial statements with parent banks.

Consolidated balances have to comply with home-country regulations.

Any decision taken by a subsidiary will take into account its impact on the parent bank's balance sheet.

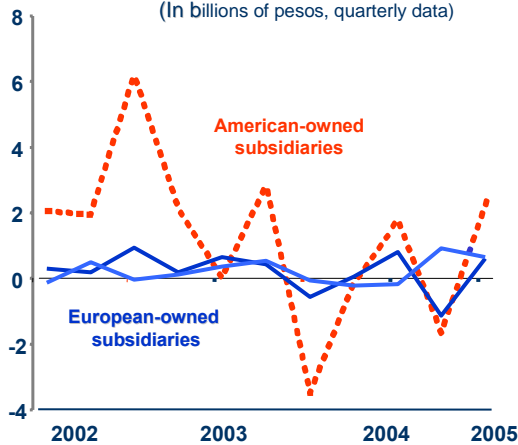
Regulatory differences between home countries might affect subsidiaries' decisions and host-country markets.

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Regulatory differences in home countries

Trading Income Reported in Host Country (MEX/GAAP)

(In billions of pesos, quarterly data)



E.g.: American and European banks are subject to different accounting standards.

Subsidiaries of banks that do not have to recognize securities' valuations in parent bank's earnings* can take larger trading positions in host countries.

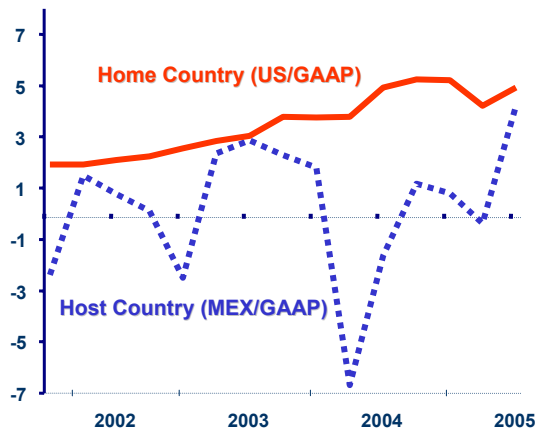
These subsidiaries will play a dominant role in host-country markets.

* US/GAAP: Changes in the fair value of available-for-sale securities are recognized in a component of stockholders' equity net of taxes. IAS and MEX/GAAP: Securities financed through repos have to be registered in trading, and changes in their fair values are recognized in earnings.



Regulatory differences in home countries

Net Income in Host and Home Countries
(In billions of pesos, quarterly data)



Subsidiaries restate their financial statements to consolidate them with parent banks.

Wide swings in income reported in host country (from large trading positions) disappear when financial statements are restated according to home-country regulation.

Home-country regulations end up prevailing over host-country ones.

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Cross-border crisis management

- Conflicts of interest between host- and home-country authorities.
- Lack of a common understanding on how to resolve failed global banks.
- Lack of supranational laws and courts.

It is important to carry out crisis simulation exercises.

- Knowledge of legal and regulatory frameworks of parent and subsidiaries' is key.
- Information must flow both ways between home and host countries.

Agreements to coordinate actions (e.g., MOU among EU countries).

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END

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