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FOREIGN BANKS: DO THEY STRENGTHEN THE FINANCIAL SYSTEMS OF LATIN AMERICA?

One of the most important characteristics of Latin American financial systems since the middle of the 1990s has been its increasing degree of internationalization. By the end of 2001 foreign ownership of bank assets (as a percentage of assets the banking system) exceeded 50 % in Argentina, Mexico, Panama, Peru, and Uruguay while it had reached between 20% and 40% in Chile, Brazil, Colombia, and Venezuela. Depending on the country, this increased participation can be explained by one or more of the following three factors. The first was the process of financial liberalization and consolidation that, together with privatizations of banks, provided incentives for foreign investment in the Latin American financial systems. The second factor was the effort to recapitalize banks in some of the countries that had experienced major systemic banking crises. Brazil and Mexico are clear examples of this. The third factor was the combination of lower expected returns on investments in more mature markets and the expected higher returns on investments in the Latin American economies as a result of the thrust of structural reforms during the 1990s.

During the second half of the 1990s, the perception of foreign bank participation in the Latin American financial systems was generally positive. This was due to several factors. First, the presence of foreign banks improved the conficence of depositors in the stability of deposits. Due to the links between the local office and the parent company located abroad, it was expected that in case of problems, the subsidiaries and affiliatees of foreign banks would have better access to financing sources that would guarantee the safety of the deposits. Secondly, it was expected that the greater availability of funding scources of foreign banks would translate into greater availability of credit in the domestic economies. And finally, it was expected that, by introducing more competition in the regional banking systems, foreign banks would significantly improve the efficiency of the banking system through cost reductions and technological improvements. As the analysis in this statement will show, these expectations were met, at least to a certain extent.

At the beginning of 2002, fear of political and legal contagion from the inadequate handling of the financial crisis in Argentina forced the parent companys of several international banks to reconsider not only their plans of expansion, but also reducing its presence in Latin America. This again generated serious concerns about the behavior of foreign banks in the region. In fact, a common perception nowadays is that foreign banks do not necessarily

constitute a stabilizing factor with a long-term commitment to the region, but rather that they tend to leave the banking sector in Latin America when faced with serious difficulties.

Although we are aware that the relatively recent nature of the significant presence of international financial institutions in the region does not allow for a full evaluation of these institutions, the present situation as well as the perspectives for the near future has forced the Latin American Shadow Financial Regulatory Committee (CLAAF) to discuss the main role that foreign banks have played in the financial systems in the region, and to analyze the major advantages and disadvantages that can be deduced from recent experiences.

The concept of foreign banking used in this declaration refers to the subsidiaries and affiliates of international banks (whose main office be located inside or outside Latin America) established throughout the region. Thus, we will not analyze the role of direct loans from parent companys of international banks to Latin America, nor shall we discuss the increasing role that foreign banking has been playing in nonbanking financial institutions in the region, such as pension funds, insurance companies, and mutual funds [1].

In order to analyze the role of foreign banks in Latin America, the Committee has identified three fundamental topics: (1) the contribution to financial stability; (2) the contribution to enhanced banking system efficiency; and (3) the new challenges for regulators and supervisors in the region, as well as for the governance of foreign banks.

The main conclusions of the Committee are:

a) During systemic crises, the behavior of foreign banks with regards to the support to be given to subsidiaries or affiliates depends on the measures taken by local authorities. The authorities must therefore carefully consider the effect that their property rights policies regarding could have on the readiness (or legal obligation) of parent companys of international banks to provide assistance to their local affiliates or subsidiaries.

b) If the authorities do not interfere with or weaken the judicial or legal institutions in the middle of a crisis, the presence of foreign banks could minimize systemic runs because depositors tend to transfer deposits to these institutions.

c) In situations of general credit contraction, no evidence exists to support the claim that foreign banks behave significantly differently from domestic banks. Nevertheless, the Committee believes that a diversification in the origin of foreign banks is desirable.

d) Empirical studies suggest that the participation of foreign banks promotes competition and technological innovation in the domestic banking system.

e) The Committee recommends that the principle of "equal treatment" of domestic and foreign capital should guide regulatory decisions with respect to authorizing the entrance of new institutions into the financial system.

[1] The exclusion of these institutions is not irrelevant given the large foreign share in this kind of financial activities. For example, the participation of foreign banks in the ownership and control of pension funds in the region is even larger than the participation of foreign banks in the local banking sector.

f) In a similar manner, the Committee maintains that there should be reciprocity on the part of regulatory authorities in industrial countries with respect to authorizing the opening of subsidiaries or affiliates of banks that have their parent company in emerging countries, accompanied by an adequate system of consolidated supervision.

g) With respect to the manner in which local activities of foreign banks should be incorporated (as a subsidiary or affiliate), the Committee emphasizes that this depends on the bankruptcy laws of the host country: Under a bankruptcy law based on the principle of *single entity*, it is recommended that foreign banks be established as subsidiaries. Under a bankruptcy law based on the principle of *separate entities*, we recommend that foreign banks be established as subsidiaries

h. The Committee recommends that banking supervision regimes and prudential regulations of foreign banks also should take into account the criteria governing bankruptcy legislation Goberning banks.When they operate under a bankruptcy law based on the concept of single entity, the Committee believes that capital and liquidity requirementsshould be applied toaffiliatesof foreign banks but not to subsidiaries. If the country adopts a bankruptcy law with the principle of separate entity, the Committee recommends that regulate\ors demand capital and liquitity requirements of both affiliates and subsidiaries.

i) The Committee supports the development of joint inspection agreements between Latin American and industrial countries. regarding the activities of affiliates. and subsidiaries of foreign bank .

j) Regarding the role as lender of last resort for banks that carry out cross-border activities, the Committee recommends that, to the extent in which local operations of a foreign bank are subject to local prudential regulations, there should be no discrimination between foreign and domestic banks when providing liquidity assistance.

k) Concerning governability, the Committee believes that, if a parent companyparent company exerts a significant influence on decision-making of a local subsidiary, it should also assume the corresponding responsibility for proving liquidity assistance, were it to be necessary.

1. Contribution to financial stability

1.1 Are the parent companies of foreign banks effective lenders of last resort?

In principle, the Committee recognizes that the willingness of the parent companies to assist its local operations can vary substantially depending on the nature of the problem in question and the type of establishment they have in the host country. If a local operation of a foreign bank becomes illiquid or insolvent because of institution-specific factors, one can expect the parent company to act as a lender of last resort or as a provider of new capital to its local undertaking, regardless of whether it is a subsidiary or an affiliate office. For example, Bank Boavista in Brazil has counted on the financial support of its shareholders, Banco Espírito Santo of Portugal and Credit Agricole of France. In contrast to what occurs in an affiliate, this action derives from a legal obligation in the case of a local subsidiary

A different situation occurs during a systemic run on deposits. In these situations the Committee concludes that the measures taken by the local authorities are vital to the behavior of foreign banks, in particular if these actions interfere with the relationship between a financial institution and its clients. In this context, the Committee has analyzed two situations that are, to a large extent, diametrically opposed. The first is the situation in Argentina, where the parent companies have not generally acted as lenders of last resort. This is because the decisions made by the authorities have had a serious impact on the value of equity and liquidity of the affiliates and subsidiaries. This has seriously undermined the willingness of the parent companies to support the affiliates and subsidiaries. (a relevant example is the so-called asymmetric pesification). The other situation is Uruguay, where the parent companies indeed have provided support for their affiliates and subsidiaries. A factor that might have contributed to this, in addition to the fact that Argentina-style measures were not resorted to, is that the market-size of Uruguay is relatively small, and that the disbursements the parent companies had to make were relatively small in comparison to the funds that they operate with. Based on these experiences the Committee believes that, when problems of macroeconomic order arise, the authorities should take into consideration the effect their policies concerning property rights might have on the willingness (or the legal obligation) of the parent companies to provide assistance to their local operations.

1.2. Does the preponderant, or very significant, presence of foreign banks make the domestic banking systems less prone to runs?

In general, foreign banks are perceived to be safer than domestic institutions, because of the volume and diversification of their operations and partly because they are subject to double supervision. Therefore, it is generally believed that the presence of foreign banks does help to make financial systems less prone to runs. Recent experience shows that when a crisis is developing, at least during an initial period, the depositors have an inclination for flight to quality, and this manifests itself in the transfer of deposits to foreign banks. In these situations, evidence suggests that parts of the resources received by foreign banks are recycled in the local system, both via the interbank market and via portfolio purchases. Sometimes, for example during the Tequila effect in Argentina, the central banks implemented measures that facilitated this recycling. Based on this, the Committee believes that in general, the presence of foreign banks contributes to improved banking system stability. In a situation without the presence of foreign banks, a systemic reduction of deposits would probably take place. Nevertheless, situations such as the one in Argentina, where legal uncertainties made the parent companies decide not to provide assistance to their subsidiaries, has weakened this conclusion.

1.3. Do foreign banks contribute to reducing or accentuating fluctuations in the creation of credit?

In some countries, there exists evidence that shocks originating in the country where the internationally active banks have their main office are transmitted to the creation of credit for their subsidiaries and that this effect tends to be procyclical. Nevertheless, some empirical studies suggest that in recent years, as the number and magnitude of foreign banks have increased, the impact produced by shocks in the countries of origin which affect countries of operation, has diminished.

Another question is if foreign banks seriously tighten credit during periods of acute crisis. On the basis of the evidence analyzed, the Committee has not found that foreign banks behave differently from domestic banks. However, there have been a few cases, like the one in Bolivia, where tightening of credit ordered by the the parent company of a foreign bank, with a large market share, on the sole basis of commercial considerations, caused a macroeconomic crisis. In this context, the Committee considers it desirable for a country to have aforeign banks of varied origin operating in the local market.

2. Contributions to improved banking system efficiency

The empirical evidence suggests that the presence of foreign banks promotes competition and technological innovation, and that it therefore improves the quality of services and reduces intermediation costs.

This is essentially due to the following reasons:

a) Because of the global and larger-scale operations of major foreign banks the return on technology investment is higher and once the technological platform has been installed, the marginal cost of extending the platform and integrating the processing of transactions to regional centers, is very low;

b) Because of its multinational nature foreign bank operations develop internal processes of benchmarking and transferring the most successful experiences throughout the whole organization;

c) The competitive advantage of foreign banks with respect to quality and cost of service, tends to put pressure on their local competitors, thus increasing the productivity of the system as a whole.

3. The new challenges for the regulators and supervisors in the region and for the governance of foreign banks.

The increased participation of foreign banks in Latin America also entails new challenges for the authorities with respect to regulatory responsibilities and supervision. In this regard, the Committee has analyzed four main questions: 1) How should the entrance of foreign banks into local financial systems be regulated? 2) Should prudential regulations for foreign institutions differ from those applicable to local banks? 3) How should international coordination of banking supervision and the role as lender of last resort for the financial institutions with cross-boarder activities be organized between regulators? and 4) Which aspects of governance and autonomy arise from increased internationalization of the financial system?

3.1. How should the entrance of foreign banks into local financial systems be regulated?

When reviewing the experience of several countries in the region during the last decade, the Committee noted the increased tendency towards reducing or eliminating restrictions on the entrance of foreign banks into the local financial systems. In many cases, this tendency originated in the banking crises of the 1990s that forced the authorities to create more

accommodating conditions to attract new external capital towards the financial system so as to compenste for the lack of domestic capital. The liberalization of entry conditions has been a crucial factor behind the increased foreign direct investment in the Latin American financial systems that has taken place since the second half of the 1990s.

In the opinion of the Committee, these regulatory developments have been positive. More specifically, the Committee believes that the principle of equal treatment should apply to domestic and foreign capital. This implies that the origin of the capital should not be a basis for discrimination, and that the decision of the regulator with respect to entrance to the financial system should be governed by prudential criteria of project viability and quality (which should also apply to its management). In this context, the Committee extends this recommendation to the countries in Latin America whose legislation does not yet adhere completely to this criterion. Furthermore, the Committee sustains that in the same way that the principle of non-discrimination should be promoted in Latin America, reciprocity in this matter should exist on the part of the regulatory authorities in industrial countries with respect to the entrance authorization into these jurisdictions of affiliates and subsidiaries of banks having their main office in Latin America subject to a suitable system of consolidated supervision.[2]

With respect to the question of how the local activities of a foreign bank, whether an affiliate or a subsidiary, should be incorporated, the Committee believes that this depends on the bankruptcy laws of the host country. If the local bankruptcy law is based on the principle of single entity (that is, in case of bankruptcy the company will be liquidated as a single entity under the jurisdiction of incorporation),then there is justification to condition that the entrance of foreign banks should be in the form of an affiliate.. This means that the local liabilities of the company are supported by corresponding local assets and capital. If the bankruptcy law is based on the principle of separate entities (that is, in case of bankruptcy the local operations of the company are liquidated under the local jurisdiction, and that any net equity be it positive or negative, will be transferred to the liquidation process in the jurisdiction of incorporation) then the local creditors of a foreign bank will be more protected if the local operations are established as a subsidiary office. If the country follows the principle usually adopted in industrialized countries, where local capital is not required of subsidiaries of foreign banks, here again the authorities are justified in demanding that foreign banks be establish as affiliates This would be in accordance with the preferences of the local regulator, that local liabilities be supported by corresponding local assets and capital. In the region, two examples of this have been Brazil and Mexico.

3.2. Should the prudential regulation of foreign banks differ from that applicable to local banks?

In accordance with the previously mentioned principle of non-discrimination, the Committee believes that banking supervision regimes and prudential regulation of foreign and local banks should be guided by similar criteria.

With the principle of non-discrimination in mind, the Committee analyzed the circumstances under which one should demand capital and liquidity requirements of the local operations of foreign banks. Here, there also exists a relationship between the applicable prudential regulations and the bankruptcy regimes in in the host country. If the local bankruptcy law

[2] This subject should be especially important for the financial aspects of the free trade agrrements currently under negotiation.

follows the single entity principle, the Committee believes there are good reasons to establish capital and liquidity requirements in the local transactions of foreign banks that operate as affiliates, but not from those local operations that operate as subsidiaries and are subject to consolidated supervision. If the bankruptcy law follows the principle of separate entities, the Committee believes that capital and liquidity requirements should be demanded from affiliates as well as from subsidiaries Today, the majority of the countries in the region follow the principle of separate entities in bankruptcy legislations.

3.3. How should regulators in different countries coordinate the functions of banking supervision and lender of last resort for the financial institutions with cross-border activities?

The Committee has followed closely the recent developments in Latin American banking supervision. On the basis of this analysis, the Committee took note of the increasing consensus of the regulators in the region on the necessity of applying consolidated banking supervision. Some countries, such as Argentina and Peru, have reached agreements with supervisors in the U.S. and the EU to conduct joint consolidated inspections of the local activities of affiliates and subsidiaries of foreign banks. The Committee believes that these practices should be encouraged throughout the region and that their adoption will make the regional financial systems less vulnerable.

While a high level of consensus has been reached as to the principle of consolidated supervision, where the responsibility of the supervision primarily falls on the regulator in the jurisdiction where the international bank has its main office, no such consensus has emerged with respect to the function as lender of last resort for the banks that engage in cross-boarder activities. This lack of consensus has been noticeable in some recent banking crises episodes in the region.

Specifically, the lack of consensus has generated two types of problems. Firstly, there have been situations (for example, during the recent crisis in Uruguay) in which, because of the lack of coordination between central banks, solvent institutions subjected to loss of deposits did not have access to liquidity support. Secondly, there have been instances (as in Argentina during the recent crisis) where the lack of understanding in this regard has led to discriminatory policies of liquidity assistance based on whether the bank is local or foreign.

Based on the analysis of these recent experiences, the Committee believes that when the local operations of a foreign bank are subject to local prudential regulations, one should not discriminate between foreign and domestic banks regarding the right to receive liquidity support. The Committee believes that the policies of liquidity support should be based strictly on economic-financial criteria, subject to the limitations imposed by monetary policy considerations.

3.4. Which aspects of governability and autonomy arise from increased internationalization of the banking system?

It is sometimes argued that a strong presence of foreign banks in the region could lead to a possible loss of national autonomy in a strategic sector of the economy. This would apply especially in a situation where the foreign banks belong to large international conglomerates, since risk analyses and decisions on credit might be undertaken, centralizing in the head

office of the bank, without proper consideration of the specific situation of the country in question. For example, a situation could occur where the international bank is over-exposed to a certain country or sector, and, at the same time, the affiliate has arranged to lend to this country and/or sector. If the head office prevails, the decision could be detrimental to the profitability of the affiliate and consequently the availability of credit. Similarly, an additional factor that might be adverse to the stability of a banking system is the possibility that a parent company, in accordance with a global policy of risk administration, should hold long positions in certain items (for example, currency positions) in one country, and compensate this by a short position in another country. Depending on the development of the markets, the losses and gains can be useful for certain purposes, say, fiscal objectives, but do not contribute to the stability of the affiliates

This presents the question of the degree of autonomy and independence that the local management team of the foreign bank has in decision-making. In this context, the Committee considers that when the head office indeed exerts a significant influence on the decision-making of its affiliate, it should also explicitly assume a corresponding responsibility for liquidity assistance, should that become necessary. At least it is necessary to to establish with due transparency on the one hand, the degree of independence and responsibility of the management of the local affiliate and, on the other hand, the obligations of the head office. The need to make explicit the rights and obligations of foreign banks presents as much of a challenge for the corporative governance of the international banks as it does for the regulatory institutions of the banking system of the countries in the region.

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