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Has Foreign Bank Entry Led to Sounder Banks in Latin America?

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Policymakers continue to debate the merits of opening emerging market financial sectors to foreign ownership. A comparison of the 1995-2000 performance of foreign and domestic banks in select Latin American countries reveals that while foreign banks differed little from their domestic counterparts in overall financial condition, they showed more robust loan growth, a more aggressive response to asset quality deterioration, and a greater ability to absorb losses—characteristics that could help to strengthen the financial systems of their host countries.

In the second half of the 1990s, foreign banks significantly increased their ownership shares of emerging market banking systems. Contributing to this increase were moves by local banking sectors to recapitalize in the wake of financial crises, as well as the broader industry trends of consolidation, privatization, and liberalization. These forces have helped bring about an especially sharp expansion of the foreign bank presence in Latin America and Eastern Europe, where foreign institutions now account for a striking 50 percent or more of system assets in a number of countries.

Foreign ownership of banks in emerging markets is often thought to improve overall bank soundness, especially when the foreign parent banks belong to well-regulated financial systems and are themselves healthy. Such parent banks are expected to provide greater access to the capital and liquidity that bolster balance sheet strength, and to transfer to local banks the skills and technology that enhance risk management and internal controls. More broadly, a foreign bank presence is expected to fortify emerging market financial systems by encouraging higher standards in auditing, accounting and disclosure, credit risk underwriting, and supervision.

But how important a role do foreign banks actually play in strengthening local banking systems?[1] In this edition of *Current Issues*, we shed light on the effects of foreign bank entry by comparing the financial condition and operating behavior of foreign and domestic banks in Latin America in the years from 1995 through 2000.[2] This period provides useful case studies, because many countries in the region experienced both a substantial increase in foreign ownership and significant macroeconomic stress. Evidence that foreign banks displayed distinctive strengths in these years would suggest that foreign participation can indeed benefit the financial systems of host countries.

Our analysis reveals that the overall financial condition and performance of foreign banks during the period was on a par with that of private domestic banks. Nevertheless, foreign banks showed higher average loan growth, a more aggressive response to asset quality deterioration, and greater loss-absorption capacity. These behavioral differences suggest that foreign banks may provide higher and more sustained credit flows than their domestic counterparts. Thus, our findings provide some support for the view that foreign ownership strengthens emerging market financial systems.

A Dramatic Increase in Foreign Ownership

Latin American financial systems changed dramatically in the latter half of the 1990s in the wake of severe banking crises. Regulatory limitations on foreign ownership were relaxed in many countries as banks coped with substantial recapitalization needs and the local banking sector sought to consolidate by privatizing inefficient state banks and eliminating marginal institutions. As a result, foreign banks now control majority shares in nearly all of the larger Latin American financial systems, with the important exceptions of Brazil and Colombia (Chart 1). These foreign banks—

predominantly from Europe and North America, especially Spain and the United States—for the most part have been highly rated and globally active institutions.[3]

The opening of Latin American financial systems to foreign banks has been accompanied by broader financial sector reforms, including enhancements to deposit insurance programs and the dedication of substantial resources to strengthening bank supervision and regulation. Measures implemented to enhance prudential supervision and regulation include higher capital requirements, more stringent loan classification and provisioning standards, and increased disclosure requirements.

The full effects of this structural and regulatory transformation on Latin American financial systems—including its impact on the systems' ability to withstand crises—are not yet known. However, it is useful to consider the initial empirical evidence. Below we examine differences in behavior across domestic and foreign banks in order to assess whether foreign bank entry might contribute to more robust financial systems in Latin America.

Data and Methodology

We use two different—though related—quantitative approaches to evaluate the soundness of individual domestic and foreign banks within Latin American countries. The first approach focuses on bank ratings, single composite measures of financial strength assigned to individual institutions by a rating agency. The second approach entails a more complex assessment of a number of variables in individual banks' financial statements. Agency ratings are a useful broad measure, but they fail to capture the particular strengths or weaknesses of individual banks; the more detailed review of financial statements makes it possible to identify specific operational and behavioral differences among banks.

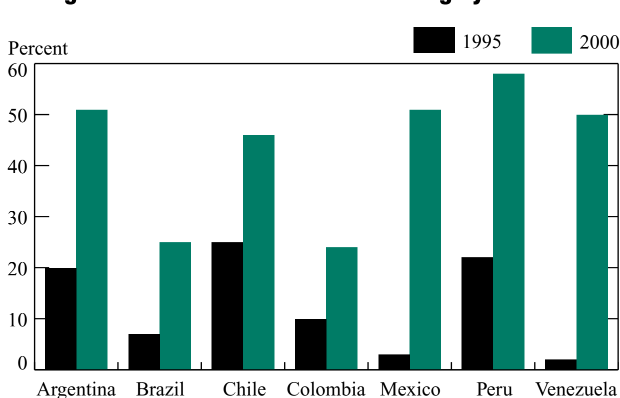
Ratings-based analysis. The bank financial strength ratings (BFSRs) issued by Moody's Investors Service are one frequently cited indicator of bank soundness. BFSRs reflect Moody's evaluation of financial strength on a scale of A to E, with A representing the highest rating.[4] Because Moody's excludes from its calculations both possible government support of domestic banks and parent bank support of foreign-owned banks, the ratings are designed to measure the *intrinsic* health of domestic and foreign banks (Moody's Investors Service 1995). The ratings also provide a relatively uniform metric over time, facilitating cross-year comparisons.

For our analysis, we track the change in Moody's ratings for sixty-seven domestic and foreign banks in seven Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela) from 1995 through 2000.[5] In addition, we construct indexes of the change in domestic bank ratings over the period relative to the change in foreign bank ratings. These relative ratings changes adjust for the timing of bank acquisitions and for events that could affect the ratings of all banks within a country.

CAMEL analysis. Our second approach to evaluating the soundness of domestic and foreign banks focuses on balance sheet and behavioral indicators. More specifically, we follow the CAMEL-style method of analysis commonly used by regulators to assess five elements of a bank's financial condition and performance: **c**apital adequacy, **a**sset quality, **m**anagement, **e**arnings, and **l**iquidity.

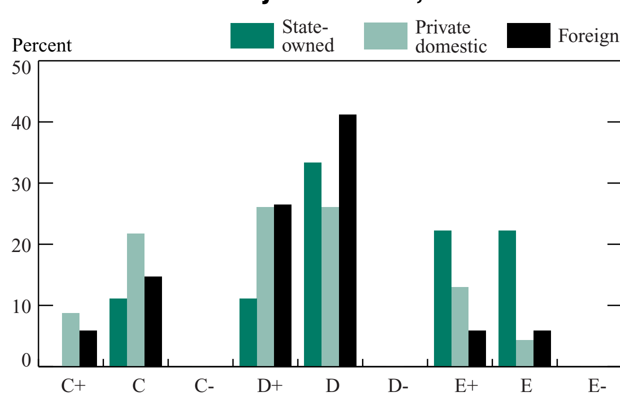
Within this framework, we examine banks in a subset of Latin American countries, with countries selected according to three criteria: a sufficient mixture of foreign and domestic banks, data availability, and a recent period of stress in the banking system. Argentina, Chile, and Colombia satisfy these criteria in the post-1997 period—

Chart 1
Foreign Share of Latin American Banking System Assets



Source: Authors' calculations, based on statistical information from local bank regulators.

Chart 2
Distribution of Banks by BFSR Values, Year-End 2000



Source: Authors' calculations, based on ratings data from Moody's Investors Service as of year-end 2000.

Note: BFSR values are bank financial strength ratings assigned by Moody's.

foreign ownership in each country ranges from 20 to 50 percent, regulators regularly publish detailed data, and each country has experienced a recession that adversely affected bank operating conditions. Our sample consists of the twenty-five to thirty largest banks in each country, capturing at least 80 percent of bank assets. We consider retail-oriented institutions exclusively.

For our analysis, we use publicly available, institution-specific data from supervisory authorities and Moody's Investors Service from 1997 to 2000 to calculate more than twenty indicators of bank condition and performance.[6] These indicators cover balance sheet structure and liquidity, asset quality, earnings, and capital.

Comparing the results for foreign and domestic banks. To compare the performance of foreign banks with those of domestic banks, we sort the results of both the ratings-based analysis and the CAMEL analysis by type of bank ownership—foreign, private domestic, and state-owned. In addition, we further divide foreign banks into those that were acquired by foreign shareholders since 1995 ("recently acquired foreign banks") and those that have maintained significant local operations at least since the early 1990s ("established foreign banks"). For our comparisons of indicators, we use unweighted averages within and across bank ownership categories.[7]

Broad Similarities in Financial Condition

The ratings-based analysis suggests that private foreign and private domestic banks did not systematically differ from each other in condition and performance over the second half of the 1990s (Chart 2). It also shows that private banks, regardless of ownership, were generally healthier than state-owned banks. The ratings of government banks are clearly skewed toward the lower end of the rating scale, while private domestic and foreign banks have similar proportions of ratings in the D or higher range.[8]

Our analysis of "absolute" and "relative" ratings changes for recently acquired foreign banks and domestic banks is somewhat more revealing. Although recently acquired foreign banks, on average, showed little improvement in their actual ratings over the period, on a relative basis they withstood downgrades attributable to broad financial and economic stress in these countries more effectively than private domestic banks. This foreign bank advantage is evident in cumulative relative ratings gains of approximately one-half of a ratings notch over those of private domestic banks.[9]

Evidence of Behavioral Differences

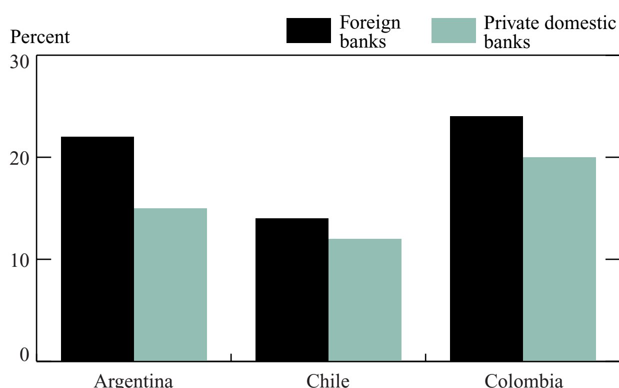
More compelling differences across ownership types emerge from the CAMEL-based comparisons of the financial statements of individual banks in Argentina, Chile, and Colombia. These differences are particularly apparent in the areas of balance sheet structure, loan growth, measures to address asset quality deterioration, and loss-absorption capacity.

Foreign banks generally rely less on deposit-based funding than private domestic banks, although both groups maintain comparable shares of demand deposits. This difference could stem from a variety of factors, but better foreign bank access to alternative funding sources is likely to be part of the explanation. Foreign banks also maintain higher shares of liquid assets—a reflection, perhaps, of their greater reliance on potentially more volatile non-deposit borrowings.

In all three countries, data through 2000 show average loan growth to be consistently higher for foreign banks than for private domestic banks (Chart 3). This result is consistent with findings by Dages, Goldberg, and Kinney (2000) that in Argentina and Mexico, foreign and private domestic banks engaged in similar lending activities in the 1990s (especially when bank

Chart 3

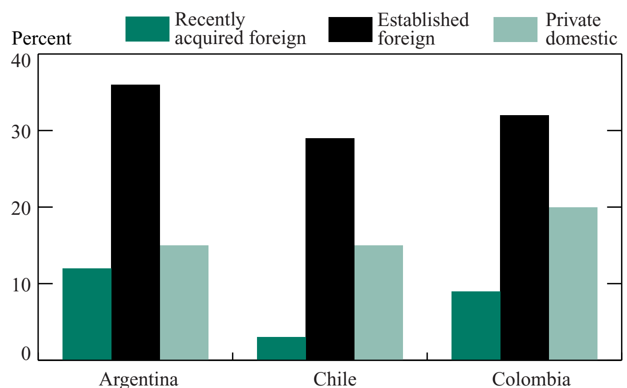
Average Annual Loan Growth, 1997-2000



Source: Authors' calculations, based on statistical information from local bank regulators.

Chart 4

Loan Growth for Recently Acquired and Established Foreign Banks, 1997-2000



Source: Authors' calculations, based on statistical information from local bank regulators.

financial condition was comparable), but foreign banks showed stronger and less volatile loan growth overall. The strength of foreign banks' loan growth may reflect their access to a broader and more diverse funding base.

However, important distinctions in loan growth rates are evident between those foreign banks with long-standing local operations and the more recent entrants. Between 1997 and 2000, established foreign banks averaged stronger and more stable loan growth than either recently acquired foreign banks or domestic banks (Chart 4). The established banks, on average, showed less reduction in credit growth when the local economy weakened and higher loan growth when conditions improved. By contrast, recently acquired foreign banks exhibited more defensive behavior, expanding their loan portfolios more slowly than domestic and established foreign banks, and acquiring a higher share of liquid assets. Such behavior suggests that the recently acquired banks may have been attending to more immediate needs—restructuring operations, cleansing balance sheets, and integrating local operations with the parent bank—rather than pursuing market share expansion and growth.[10]

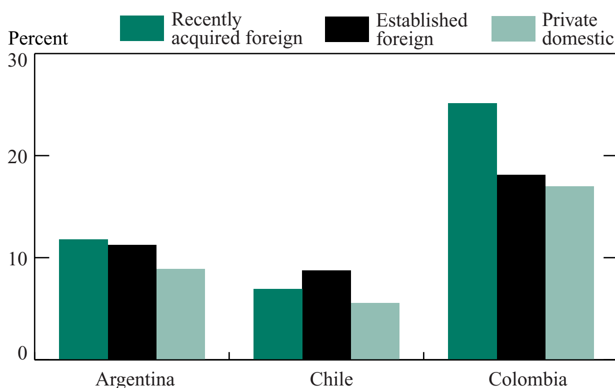
A key issue to watch going forward is the extent to which foreign and private domestic banks rely on different funding sources, and the associated implications for loan growth stability. If foreign bank lending draws on funding sources from the parent country, it may be more vulnerable to macroeconomic deterioration at home than in the emerging markets. Using data through 2000, Goldberg (2001) shows that movements in U.S. bank lending to Latin American countries were more closely tied to economic conditions in the parent country than to conditions in the host country; indeed, when crises occurred in Latin America during this period, U.S. lenders did not "cut and run."[11] With economic slowdowns under way in the United States and Europe, data releases for 2001 and into 2002 will reveal whether the more robust lending by foreign banks in Latin America withstands these slowdowns.

An evaluation of the quality of bank lending, as measured by the level and trend of nonperforming loan ratios, is inconclusive. Ambiguous results, however, may reflect traditional difficulties in evaluating bank asset quality by outside analysts: definitions of problem loans across countries often vary widely, and individual banks within a country may apply the same standard differently.

Nevertheless, data on bank provisioning for bad loans reveal systematic differences between foreign and private domestic banks (Chart 5). Foreign banks had higher loan provisioning expenses and comparable or higher reserve coverage of nonperforming loans. Together, these findings may suggest that foreign banks had tighter credit review standards than domestic banks. The higher average recoveries on charged-off loans at foreign banks could also point to more intensive or effective workout procedures, or simply to a higher level of average charge-offs. Recently acquired banks in particular took strong measures to address potential losses, typically having reported higher initial problem loan levels and correspondingly higher provisioning and recoveries. Such actions were not exclusive to the new foreign bank entrants absorbing weaker institutions, however: established foreign banks—which began the sample period with nonperforming loan ratios similar to or lower than those of private domestic banks—also provisioned more heavily than their domestic counterparts. Overall, the data show that foreign banks were more aggressive in addressing asset quality deterioration.

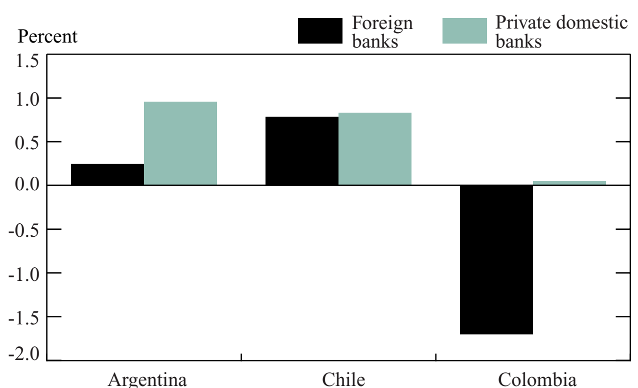
At least in the short run, higher provisioning contributed to generally weaker profitability at foreign banks—an outcome reflected in lower returns on assets (Chart 6). Foreign banks also had net interest margins similar to or lower than those of domestic banks, and

Chart 5
Average Ratio of Bank Provisions to Loans, 1997-2000



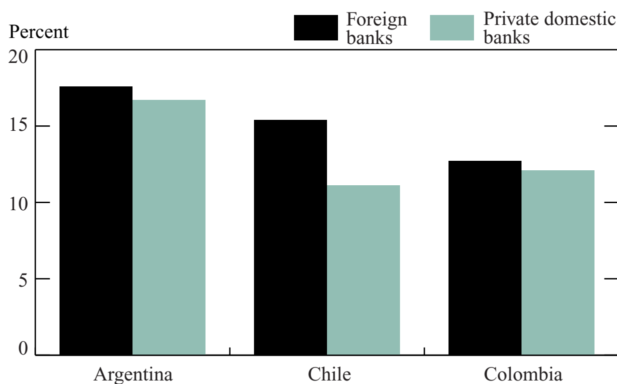
Source: Authors' calculations, based on statistical information from local bank regulators.

Chart 6
Average Return on Assets, 1997-2000



Source: Authors' calculations, based on statistical information from local bank regulators.

Chart 7
Average Risk-Based Capital Ratios, 1997-2000



Source: Authors' calculations, based on statistical information from local bank regulators.

comparable or higher non-interest expense.[12] Lower average net interest margins at foreign banks likely reflect larger investments in lower-yielding liquid assets, but could also reflect more expensive non-demand-deposit financing. Higher non-interest expenses, meanwhile, may be the result of short-term post-merger consolidation.

Despite relative profit weakness, foreign banks consistently maintained higher average risk-based capital ratios than private domestic banks in all three countries (Chart 7).[13] This pattern is particularly notable in Colombia, where foreign banks suffered losses through 2000. Higher foreign bank risk-based capital ratios reflect relatively larger investments in liquid and lower-risk assets. The combination of higher risk-based capital ratios and lower capital-to-assets ratios for foreign banks in Argentina and Colombia suggests that foreign banks in these countries may also allocate capital in a way that more closely mirrors the riskiness of their assets, and hence may allocate this capital more efficiently.

A Contribution to Banking System Soundness in Latin America

Our analysis has revealed substantial similarities in the financial strength and performance of foreign and private domestic banks in Latin America during the period between 1995 and the end of 2000, with both outperforming state-owned banks. Ratings data indicate that local banks acquired by foreign shareholders fared only marginally better than those banks that remained under domestic control during recent periods of widespread financial and economic stress. The lack of major differences in overall performance suggests that strong domestic and foreign banks can compete effectively in local banking markets.

Despite the broad similarities in the performance of foreign and domestic banks, however, our more detailed evaluation of bank financial statements in three Latin American countries reveals significant behavioral differences. Foreign banks tended to maintain greater asset liquidity and relied less on deposit financing. In addition, foreign banks, particularly those with established in-country operations, typically showed stronger loan growth than private domestic banks, even during periods of local economic difficulty. Although recently acquired banks had weaker loan growth, their focus on balance sheet repair could lay the foundation for future credit growth at a pace much closer to that set by established foreign banks.

Across the board, foreign banks provisioned more aggressively against bad loans and had higher loan recovery rates. These actions point to tighter credit review policies and practices. They are also suggestive of more efficient overall financial intermediation, since banks that take such precautions are able to identify weak credits earlier and to reallocate their resources more quickly. Although foreign banks as a group presented weaker profitability profiles, they maintained higher risk-based capital ratios than did private domestic banks. Foreign banks seemed more willing to tolerate, or could better afford, lower returns in the near term for the sake of building longer-term institutional strength. Such an approach signals a strong commitment to local markets.

Our findings support the potential for foreign ownership—at least from globally active and healthy parent banks—to contribute to sounder and more stable banking systems in emerging markets. Nevertheless, more extensive analysis of these issues is clearly warranted. The ownership changes in Latin America remain relatively recent, and have taken place during a period when local economic conditions have been difficult while home-country conditions for foreign parent banks have been strong. The competitive dynamics of substantially increased foreign ownership in other macroeconomic settings will be more fully revealed with the passage of time.

Notes

1. Since large-scale foreign bank entry into emerging markets is relatively recent, the empirical evidence of its effects is only beginning to emerge. One effect documented in several studies, however, is that foreign entry contributes to greater competition for domestically owned banks, leading to lower local profit margins but also to improved local bank efficiency. See especially Martinez-Peria and Schmukler (1999). Related analyses appear in Burdisso, D'Amato, and Molinari (1998); Claessens, Demirguc-Kunt, and Huizinga (1998); and Clarke, Cull, D'Amato, and Molinari (1999).

2. A more extensive discussion is provided in Crystal, Dages, and Goldberg (2001). Throughout this analysis, banks are considered to be foreign if foreign shareholders own a majority of voting shares or exercise effective management control.

3. We do not conduct a systematic comparison of foreign banks based on nationality.

4. Ratings categories are defined by Moody's as follows: A is "exceptional"; B, "strong"; C, "good"; D, "adequate"; and E, "very

weak." Distinctions among banks are also made by the assignment of pluses and minuses to bank ratings.

5. The financial strength ratings for banks in our sample were provided by Moody's Investors Service.

6. See Banco Central de la República Argentina, *Estadisticas Financieras*; Superintendencia de Bancos e Instituciones Financieras Chile, *Información Financiera*; Superintendencia Bancaria de Colombia, *Estadisticas Financieras*; and Moody's banking statistical supplements for Argentina, Chile, and Mexico.

7. We use unweighted averages to evaluate the effects of foreign ownership at the institutional level without giving consideration to relative size. Thus, results should not be interpreted as precise indicators of the level or trend of the overall condition and performance of the banking sector. Moreover, bank financial results are prepared in accordance with local accounting and regulatory standards and are not necessarily comparable internationally or across the three countries. Individual banks or ownership types may also apply existing standards more or less rigorously.

8. Between 1995 and 2000, no Latin American bank was rated higher than C+ (considered "good" by Moody's).

9. By way of example, a move from D to D+ represents one ratings notch.

10. While we did not specifically control for size and associated base effects, the loan portfolios of small foreign banks expanded more rapidly than those of private domestic banks of comparable size. Loan growth at larger foreign banks was slower than at domestic peers, although this appears to reflect acquisition and merger-absorption issues.

11. Peek and Rosengren (2000) and Palmer (2000) report similar findings.

12. By contrast, foreign banks' non-interest income levels as a percent of total assets varied widely across the three countries, ranging from relatively high in Chile (and much above those of domestic banks), to low in Argentina (but comparable to domestic bank levels). This result may reflect the relatively greater development of Chilean financial markets, where foreign banks might be better able to exploit comparative advantages in such areas as trading, investment banking, and asset management.

13. Risk-based capital ratios measure capital relative to assets adjusted for credit risk. The countries under review have adopted risk-based capital frameworks that are broadly consistent with the Basel capital adequacy guidelines.

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