International Financial Conglomerates: The Perspective of an Expanding Emerging Financial System

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International financial conglomerates (IFCs) have increasingly become an important part of the financial system in both advanced and emerging economies (Herring and Carmassi [2010]). Several factors can explain this trend. Firstly, the expansion of IFCs has followed the pace of the internationalization of the markets for goods and services, improving the ability of economic agents to exploit trade and investment opportunities in several jurisdictions at the same time.

In some cases, they are a natural consequence of the growth of trade in goods and services among countries, given geopolitical factors such as their closeness. The latter has been stimulated by the trend toward globalization of trade and by the improvements in communication technologies. The expansion of IFCs has also exploited investment opportunities in emerging markets in a context of secular stagnation in advanced economies and increased growth and macroeconomic stability in developing economies.

Another factor that must be considered is that, as an unexpected consequence of the international financial crisis and the reforms adopted to strengthen the global financial system, regional financial entities expanded their operation, taking advantage of the business opportunities left behind by global entities that decided to sell their business activities from several emerging markets during and after the crisis of 2008-2009. Some of these global actors had to leave the region following

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instructions by their supervisors, or with the idea of focusing their efforts in more relevant markets. Local or regional institutions took advantage of this circumstance.

The trend towards the expansion of local financial institutions into other jurisdictions is welcome. However, the new circumstances pose a number of challenges to regulatory and supervising authorities in both host and home countries that should be confronted in order to avoid some of the potential downsides of the expansion of IFCs that outweigh its significant benefits.

The aim of this note is to present some comments on the expansion of IFCs from the point of view of the Colombian experience, where the recent expansion of local banks into other emerging markets (particularly Central America and the Caribbean) has been remarkable.

The note is organized as follows: The first section tries to answer why the expansion of IFCs deserves the attention of policymakers in both host and origin countries; the second section provides a perspective on the specific case of the recent growth of Colombian IFCs; the third section briefly discusses some features of a roadmap for regulatory and monetary authorities with regard to IFCs; finally, the fourth section provides some reflections as concluding comments.

1. Why the expansion deserves attention from regulators and policymakers

As was mentioned above, several potential benefits arise from the expansion of IFCs in emerging markets. Firstly, the growth of financial institutions overseas allows them to have a more diversified portfolio of investments, making them less vulnerable to those shocks occurring within a particular market, thus promoting macroeconomic and financial stability in both host and origin countries. At the same time, the presence of domestic banks overseas enhances the ability of economic agents from different jurisdictions to exploit investment opportunities in different markets. IFCs play the role of a hinge between real sectors belonging to different economies. All these elements contribute to the capacity of home and host economies to absorb and smooth domestic and external shocks and to their ability to better connect to international goods and financial markets.

In order to reap these benefits, however, a number of policy challenges regarding the expansion of IFCs needs to be confronted. Although it is true that domestic banks that expand overseas are exposed to different financial and non-financial shocks, the main challenge arises from the different approaches—potentially conflictive—of the financial regulation and the capacity of central banks to provide liquidity to the different jurisdictions. This is a vital issue, especially when regulatory and supervising practices are dissimilar. By looking at Latin American countries, it may be seen that many of them are at different stages of applying best practices regarding financial regulation and supervision. Particularly, many of the countries are in the stage of an early implementation of the best capital and liquidity requirements as well as of risk-based supervision. This can exacerbate some risks on the side of financial entities.

At least four dimensions of this problem are particularly relevant. Firstly, these differences may lead financial institutions to try to take advantage of the opportunities entailing regulatory and supervisory arbitrage; secondly, differences in bankruptcy procedures may create inefficiencies and become sources of future litigation; thirdly, differences in the procedures of Central Banks as lenders of last resort (LOLR) may hamper the capacity of financial institutions to withstand liquidity shocks in different jurisdictions (there may also be uncertainty as to what extent a particular LOLR is open to solve situations in which the liquidity shocks coming from subsidiaries of financial institutions operating in other jurisdictions). One last aspect to consider is that some risks may increase given the macroeconomic characteristics of the countries with different currency-exchange regimes, thus generating possible currency exchange mismatches to the IFCs.

Naturally, these issues would not be relevant if regulation were perfectly coordinated across jurisdictions where IFCs participate. Therefore, it is necessary to continue making efforts towards the harmonization and international coordination of regulation applicable to all jurisdictions. In this sense, the joint convergence of individual jurisdictions to a common regulatory framework on IFCs following the roadmap set out by the Basel Committee on Banking Supervision (BCBS[2012]) is a desirable outcome.

However, it is crucial to recognize that a complete harmonization is impractical (and not necessarily desirable). As a result, there is scope for regulators and policymakers at the level of individual jurisdictions to introduce mechanisms that prevent excessive regulatory arbitrage and allow for a smooth transmission of shocks across borders with the aim of promoting domestic financial stability. The support that the IMF has been providing to Central American countries in pursuance of a common framework for financial regulation and supervision is a good example of how international technical cooperation may cause a positive impact.

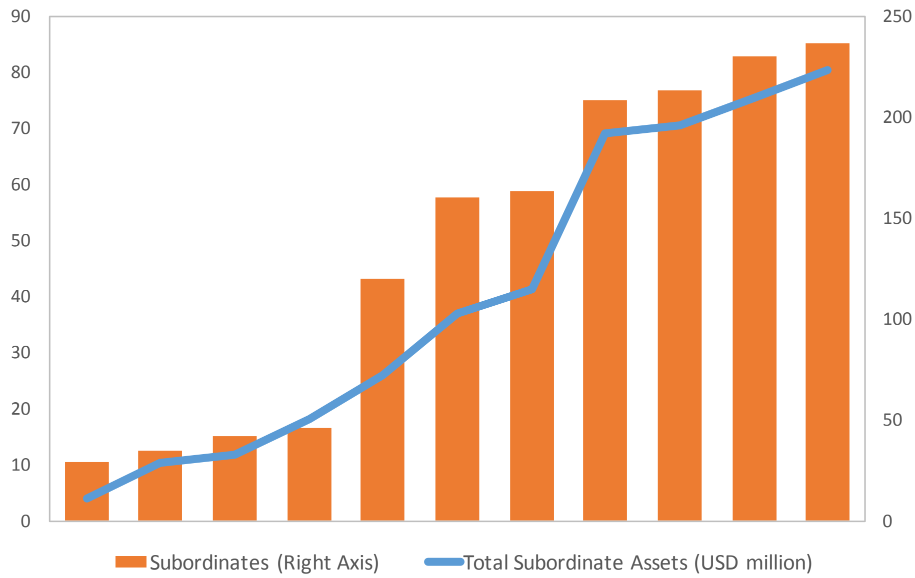
2. The expansion of Colombian financial conglomerates abroad

Since 2007, several Colombian financial institutions have decisively expanded their operations abroad, quickly becoming IFCs and important financial players in the region. While in 2006 there was abroad a total of 26 subordinate financial institutions belonging to Colombian banks, with a combined amount of assets of USD 3.8b, at the end of the first quarter of 2016 there were 236 subordinates with assets totaling over USD 80.4b, corresponding to 40.1% of the total assets of Colombian credit institutions (see Figure 1).

The largest acquisitions of Colombian banks during this period have occurred mostly in Central America, as can be gleaned from Table 1. Specifically, the three largest transactions corresponded to the acquisition by Grupo Suramericana of AFP ING Latinoamérica (USD 3.6b), the purchase of BAC by the Grupo Aval (USD 1.9b) and the acquisition of HSBC Panamá by Bancolombia (USD 2.2b). The incursion of Colombian banks has radically altered the financial landscape: by the end of the first quarter of 2016, the share of assets held by subordinates of Colombian IFCs was 53.3% in El Salvador, 23.4% in Nicaragua, 22.3% in Panama, 18.7% in Honduras, 17.4% in Costa Rica and 17.1% in Guatemala.

Figure 1

Expansion of Colombian IFCs, 2006-2016



The expansion of Colombian IFCs has responded to several concurrent causes. In the first place, as a response to the needs of their clients from the real sector. The growth of these operations required the evolution from simple representation offices to a more integral platform, leading Colombian banks to set up subsidiaries with ample licenses in host countries. As was already mentioned, a second reason that explains the rapid growth of Colombian IFCs was the vacuum left by IFCs from advanced economies who pulled out from the region as a consequence of the global financial crisis of 2008-2009 and subsequent stiffening of regulation. Finally, a friendly regulatory environment towards international investors, knowledge of the market, and cultural similarities led Colombian banks to expand specifically in Central America, which had the additional attractive of a good profitability and huge opportunities to introduce new products and services in these countries.

It is worth highlighting that this expansion covers not only the banking industry in Central American countries, but also countries such as Peru and Paraguay, of insurance companies in almost all Latin American countries, and those of financial services associated with the administration of pension funds in the continent.

Table 1

Country distribution of financial subordinates of Colombian IFCs, end-2016

Region	Country	Financial Subordinates
South America	Argentina	3
	Brazil	1
	Chile	9
	Ecuador	2
	Paraguay	1
	Peru	10
	Uruguay	4
Subtotal		*30*
Central America and the Caribbean	Bahamas	2
	Barbados	2
	Costa Rica	16
	Curacao	1
	El Salvador	19
	Guatemala	14
	Honduras	4
	Cayman Islands	5
	Nicaragua	3
	Panama	37
	Dominican Republic	1
Subtotal		*104*
North America	United States	1
	Mexico	6
	Puerto Rico	1
Subtotal		*8*
Europe	Spain	1
Subtotal		*1*

3. Monetary policy and regulation: the road thus far

The rapid growth of Colombian IFCs illustrates the challenges for regulation and financial supervision, and has determined the regulatory agenda of Colombian authorities.

In the arena of financial regulation, financial institutions seeking to expand abroad must (before any move overseas) request permission to the Financial Superintendency (SFC), which in turn imposes requirements on information disclosure, corporate government, and risk management. In addition, the SFC has actively participated in efforts to establish protocols for sharing information across the region, and has pioneered in the organization of several collegiate supervisors, following the best practices. The SFC is a permanent member of the Central American Council of Financial Superintendents (CCSBSO), that constitutes an outstand scenario for the coordination and follow-up of the Central American financial system.

However, as the activities of local banks became more important abroad, the need to extend the perimeter for supervision was made evident so as to cover controlling entities (holdings) of financial conglomerates. This legal reform was identified by the SFC and supported by the World Bank and the IMF during the 2013 Colombian FSAP exercise (IMF[2013]). It was also one of the recommendations issued by the OECD as part of the Colombian process for membership of the organization.

In late September 2017, the Congress of Colombia issued Act 1870, which regulated the regime of financial conglomerates, establishing a wide definition that allows to incorporate within the law different financial groups, including, under supervision of the the SFC, the controlling entities, even not of financial nature, and granted faculties to the SFC to perform consolidated supervision effectively.

This new law is the result of a careful discussion process with legislative organs and the industry, which acknowledged the importance of the new regulation. As mentioned, the law: (i) extends the perimeter of supervision to holding companies, (ii) empowers the regulator and the supervisor to establish capital requirements to the financial conglomerate, (iii) gives powers to the SFC to demand that the risk evaluation be done at the level of the financial conglomerate, (iv) gives powers to the SFC to demand, if necessary, changes to its structure and corporate government with the purpose of ensuring duly supervision, regulating the operations with related parties, and (v) in general, to demand any information necessary for the supervision tasks.

Allow me to mention the challenges that the expansion of the IFCs brings to monetary policy. Firstly, IFCs sometimes operate in dollarized economies in which the provision of liquidity may be limited or where there may not be LOLR mechanisms. A concern for *Banco de la República* is to incorporate in the supervising processes a good monitoring of this risk[2]. Secondly, liquidity shocks in host countries may have an impact (via the endogenous response of IFCs) on foreign exchange markets of origin countries. In the case of Colombian IFCs, it is well known that many Central American countries feature relatively high levels of financial dollarization and low levels of international reserves relative to the size of bank liabilities denominated in foreign currency (see Bolaños Zamora[2013]). Finally, the role of monetary policy in macroeconomic stabilization may be further complicated by the growth of IFCs overseas. The economies in which Colombian IFCs operate, for instance, are commonly small and open but differ widely in terms of size, trade partners, exchange rate regimes and business cycle synchronization. In this sense, the expansion of Colombian IFCs naturally generates more complexity with regard to the specific mechanisms through which external shocks may affect the Colombian economy and financial system. An interesting example in this respect is the recent turbulence in public debt markets of several Central American economies, some of which have suffered downgrades by rating agencies, thus affecting the portfolios of Colombian banks operating within those jurisdictions.

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[2] At the moment, *Banco de la República* is conducting a survey of LOLR facilities across those jurisdictions where Colombian IFCs have expanded, with two objectives: first, to better understand the virtues and pitfalls of these mechanisms in different countries; second, to identify potential risks that may emerge from differences in liquidity support mechanisms.

It is important to mention that these concerns of the monetary authority are shared by the supervisor; hence, coordination between the two entities is an indispensable condition because they share the purpose of financial stability.

An additional step is the coordination among central banks. *Banco de la República* currently participates in the Central-American Monetary Council, which produces a financial stability report jointly made by the supervisors in the area. However, there is a very wide agenda still to be explored and developed with central banks in the region.

4. As a conclusion

The internationalization of financial conglomerates in emerging markets, in the context of increased globalization of trade and financial flows, is a natural, healthy outcome, which should be welcome and incentivized by regulatory authorities and policymakers in both origin and host countries. It has the potential of promoting economic growth (by providing closer ties with international markets and allowing the exploitation of gains from trade) and financial stability (through the diversification of investment portfolios of domestic financial institutions).

To crystallize these potential benefits, regulatory and policy action is required despite the many advances thus far. Specifically, it is necessary to make headway, together with the authorities from other jurisdictions in coordinating joint actions among central banks and the entities in charge of banking resolution, with protocols that enable them to act in a synchronized manner facing situations that for example may imply banking intervention. Similarly, it is necessary to continue fostering best practices in regulation and supervision by the ICFs in host countries, especially regarding risk measurement and control.

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