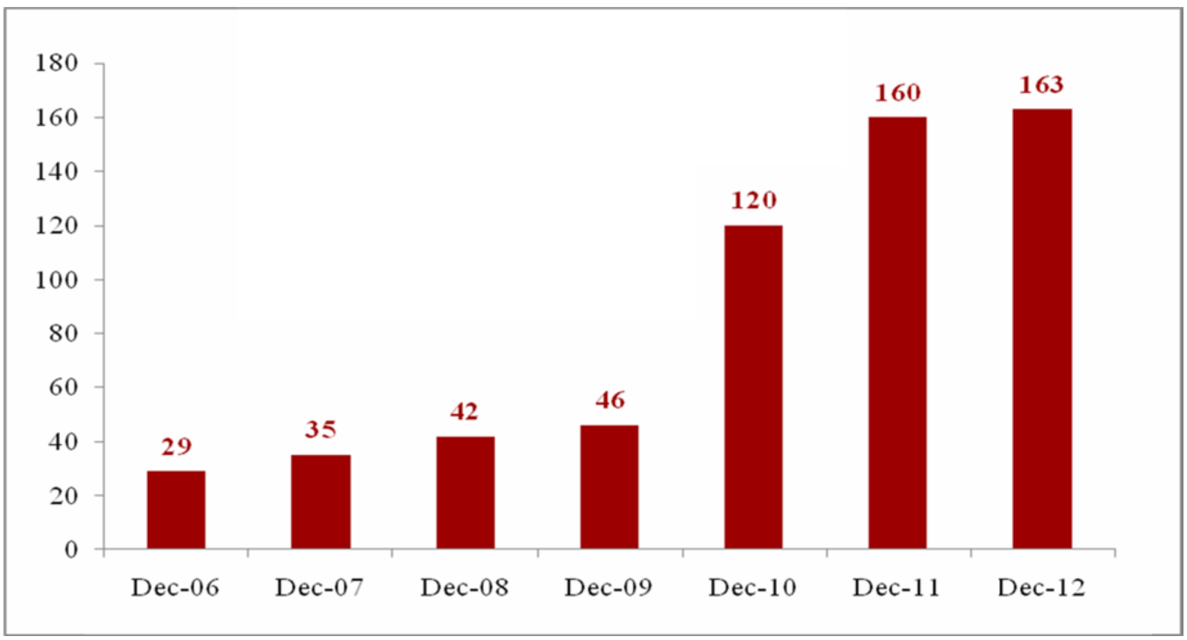
Internationalization of Colombian banks:
Recent developments and challenges for supervision

1. Background

In recent years, Colombian financial conglomerates (CFCs) have shown a significant expansion abroad. While in December 2006 these conglomerates had a total of 29 subsidiaries in December 2012 the Financial Superintendence of Colombia (FSC) identified 163 (Figure 1), of which 103 were located in Panama, El Salvador, Costa Rica, Guatemala, Honduras and Nicaragua (Figure 2).

Figure 1: Number of CFCs foreign subsidiaries



Source: FSC

Between December 2006 and December 2012, the main overseas expansion of CFCs was due to the acquisition of assets of Banagricola by *Bancolombi*a, BAC Credomatic by *Banco de Bogotá*, HSBC in Central America and the Caribbean by *Davivienda*, and the ING Group in different countries in Latin America by *Suramericana*. From 2007 to 2012 the Colombian financial system invested nearly USD $8.2 billion to achieve this expansion. Actually, the share of credit extended by CFCs' foreign subsidiaries represents 31% of *Banco de Bogotá*, 24% of *Bancolombia* and 17% for *Davivienda*. Similarly, 40% of *Banco de Bogotá*'s current clients live abroad, 15% of *Bancolombia'*s and 17% of *Davivienda*'s.

Figure 2: Distribution of CFCs subsidiaries by geographic region and country

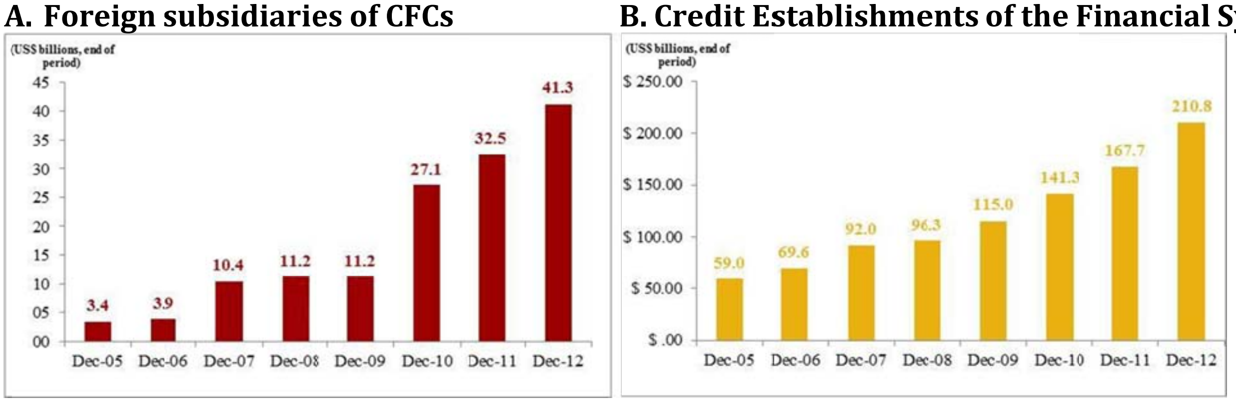
Central America and the Caribbean	Panama	33
	El Salvador	23
	Costa Rica	21
	Guatemala	11
	Honduras	9
	Nicaragua	6
	Cayman Islands	6
	British Virgin Islands	3
	The Bahamas	2
	Dominican Republic	1
	Barbados	1
	Puerto Rico	1
North America	Mexico	14
	United States of America	4
South America	Chile	10
	Peru	10
	Uruguay	1
Europe	Netherlands	6
	Spain	1
Total		**163**

Source: FSC

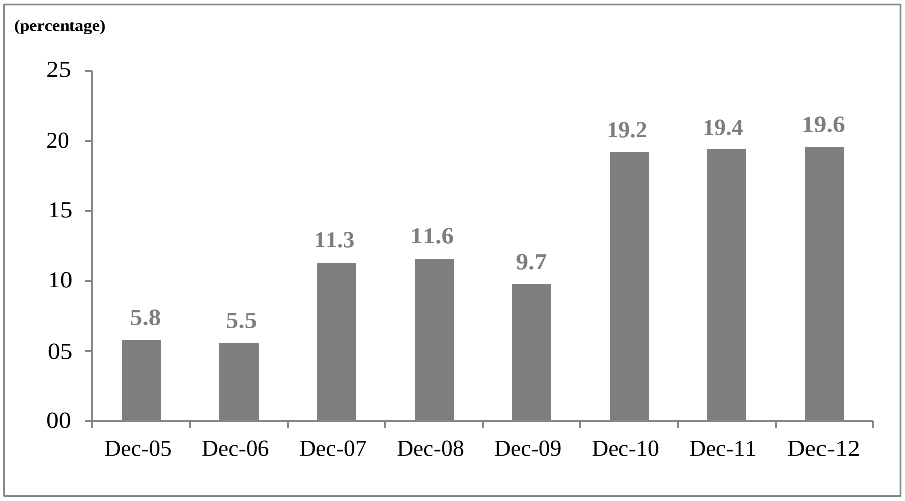
As of December 2012, the assets of the CFCs' foreign subsidiaries amounted to USD $41.3 billion, which represented 19.6% of the total assets managed by credit establishments that operated locally in the Colombian Financial system, and is significantly higher than the 5.8% figure registered by the end of 2005 (Figure 3, Panel C). Moreover, it is noteworthy that during this period the assets of the subsidiaries abroad grew, on average, at a nominal annual rate of 54.2%, while for local entities the figure stood at 20.2%.

Figure 3: Value of assets held by subsidiaries and of local credit institutions of the financial system

A. Foreign subsidiaries of CFCs **B. Credit Establishments of the Financial System**



C. Share of Subsidiary Assets in the Colombian Financial System

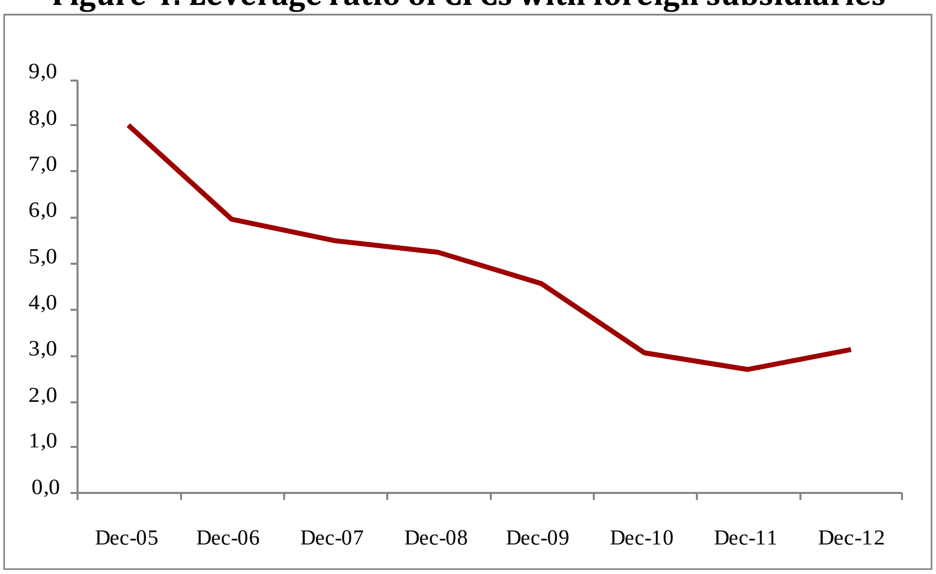


Source: FSC; estimates of the *Banco de la República*

Note: The figures in Panel B were converted to dollars using the market exchange rate for the last day of the period.

Subsidiaries' equity has increased significantly in recent years as it has gone from 12% of total assets in December of 2005 to 37% in December of 2011. This means that since 2005 asset growth has been accompanied by an even greater increase in equity and, therefore, has represented a decrease in the leverage ratio (total assets / equity) from more than 8 in 2005 to around 3 in 2012 (Figure 4).

Figure 4: Leverage ratio of CFCs with foreign subsidiaries

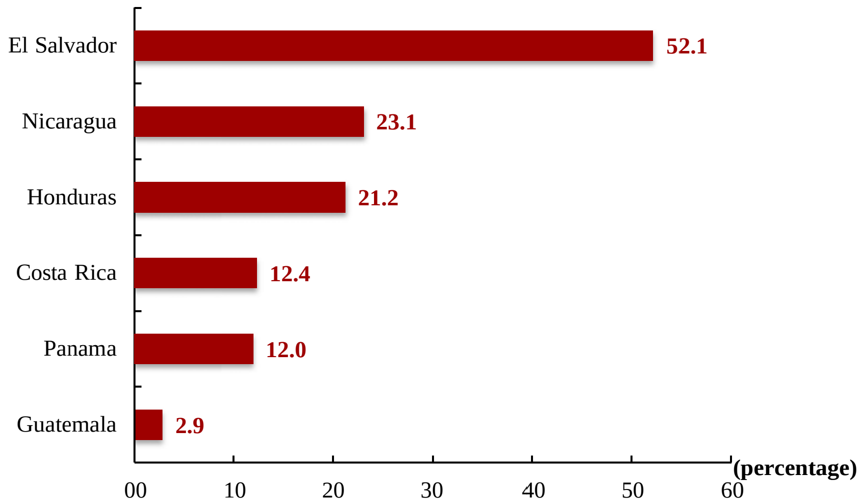


Source: FSC; estimates of the *Banco de la República*

Given the relevance of Central America for CFCs, it is also important to calculate the share of assets these entities hold in the banking system of each country in the region. As shown in Figure 5, as of

December 2012 the highest share was in El Salvador (52.7%), followed by Nicaragua (22.6%), Honduras (21%) and Costa Rica (12.8 %). Although Panama hosts the largest number of entities (33) the asset share of Colombian subordinates in the Panamanian banking system is 11.9%, about half of the figures calculated for Nicaragua and Honduras (where no more than 10 entities are located).

Figure 5: Ratio of the total assets of the Colombian financial conglomerates abroad to the total assets of the local banking system (by country)



Note: Figures for December 2012

Source: FSC, estimates of the *Banco de la República*

2. Determinants of the expansion of Colombian banks

The expansions of Colombian banks abroad can be explained by both pull and push factors. First of all, the deterioration and deleveraging of banks from advanced economies opened the field for greater participation of banks from emerging economies in the region. Second, the strength and broad access of Colombian banks to international financial markets enabled them to spread overseas.

Since the global financial crisis banks from advanced economies have been deleveraging. During the years before the crisis those banks maintained high levels of leverage in order to sustain the expansion of credit in local and cross-border markets. However, the 2008 crisis brought about greater pressure from regulators and supervisors regarding higher capital requirements at the entity and group levels as well as the required adoption of Basel III standards and forced them to reduce leverage. This led to the sales of businesses that were not considered 'strategic' and which were largely located in emerging economies.

At the same time, Colombia's strong economic performance, its sovereign rating upgrades and the positive environment in Latin America resulted in a favorable situation for financing acquisitions abroad on the basis of either their own resources and the issuance of shares, or bonds in global and local capital markets. In addition, Central America represented an economic opportunity for CFCs.

In recent years Colombian banks' interest margins have decreased and the return on capital has fallen from levels that were close to 23% before 2009 to 15.5% in 2012. In contrast, Central America has higher margins and higher fees for financial services, and returns on capital are similar to those that Colombia had before the global crisis. Moreover, low barriers to entry, an investor-friendly legislation with no recent episodes of nationalizations, and a perceived level of financial development similar to the conditions Colombia faced some years ago attracted Colombian investment to those countries.

3. Regulatory and Macroeconomic Implications of the Expansion of Financial Conglomerates

The expansions of CFCs abroad have benefits for the Colombian economy and financial system. The Colombian economy and the new host regions are subject to different shocks or respond differently to common shocks. As a result, there is an increased diversification of macroeconomic and financial risks stemming from the investments of CFCs in the region. Nevertheless, in order to reap those benefits, Colombian authorities must overcome some regulatory and macroeconomic challenges.

a. Regulatory challenges

The recent expansion of the CFCs has exacerbated two difficulties that come with the supervision of financial conglomerates in Colombia. First, while the FSC collects financial statements of the intermediaries on a monthly basis, the consolidated information of the CFCs has a semester periodicity and has a lag of six months[1]. Therefore, the periodicity of the consolidated financial information of the banking groups does not match the one for the individual entities and does not reflect the current soundness of the CFCs. Second, the consolidated supervision of the CFCs does not cover unregulated firms, so relevant indicators, such as the capital adequacy ratio, reflect only the situation for the consolidated supervised entities. This aspect could be solved if not only the financial and regulated entities but also the holding companies are subject to supervision by the FSC. Such a change requires a modification of the law and is under discussion among Colombian authorities.

Since the most important CFCs have been expanding recently to Latin-American jurisdictions, particularly Central American countries, the quality of the financial information of their subsidiaries implies two important limitations for the FSC. In the first place, the host country information requirements of their supervised entities could not comply with the Colombian

[1] Given that neither Colombia nor the various jurisdictions where CFCs hold investments have yet adopted the International Financial Reporting Standards (IFRS), this indicator is calculated after the process of homologation of financial accounts. Such process of homogenization is based on Colombian prudential regulations in order to guarantee the quality of the consolidation. At this time there is a schedule of implementation of IFRS in Colombia to be completed in late 2015.

standards, and therefore, the consolidated supervision of the CFCs could be weakened. In addition, the acquisition of a subsidiary can be made directly by the parent company or by means of a special purpose entity. In the first case, the FSC can have, at a consolidated level, the information and claims of the subsidiary. However for the second scenario, it is only possible to consolidate the financial information of the special purpose entity and not necessarily of the relevant subsidiary. Hence, it is difficult to track its exposure to different risks prevailing in the host economy.

Therefore, at the present moment, the FSC faces three important challenges regarding the supervision of CFCs that have shown an important expansion abroad in recent years:

- The establishment of clear coordination processes with the host supervisor in order to define the roles and responsibilities of each one. The coordination processes are crucial since they delegate tasks and ensure the effective distribution of information, as well as provide resolution procedures, and other parameters for cooperation.
- The powers of the FSC in foreign jurisdictions face challenges, particularly with regards to the quality and quantity of the information the host supervisor can deliver. In addition, the periodicity and disaggregation level of the information is heterogeneous among countries, making the collection and processing of information difficult.
- The CFCs must comply with different FSC requirements in order to receive authorization of investments in assets abroad ('checklist'). Among the documents reviewed by the FSC, it is required that these entities submit an "Analysis of the risks the subsidiary could potentially face and the suggested risk management". However, the current regulation lacks the proper framework that supervised institutions must follow for managing country and transfer risks of their overseas subsidiaries under a standard methodology and periodicity.

In spite of these challenges, the FSC has made significant progress in recent years regarding the supervision of financial conglomerates. With respect to corporate governance, the FSC created a department that is exclusively responsible for that task[2]. Moreover, the FSC has adopted the creation of voluntary codes of corporate governance that are issued annually for conglomerates.

In addition, the FSC has worked with supervising entities in the principal countries where CFCs are present. They have signed memoranda of understandings and have instituted colleges of supervisors that share knowledge on the risks of financial conglomerates. This achievement is worth noting, taking into consideration that the Basel Committee of Banking Supervision, in their principles for the supervision of financial conglomerates, highlights the necessity of a coordination process between the home and host supervisors[3].

Finally, the Colombian Central Bank (*Banco de la República*) faces important challenges with the expansion of CFCs abroad. On one hand, some CFCs operate in dollarized economies with no lender of last resort. Therefore, the monitoring of liquidity risk of Colombian banks abroad is a main concern for the Central Bank. On the other hand, a liquidity shock in the countries where

[2] This department is in charge of ensuring that the supervised institutions have adequate governance structures that generate fairness, integrity, accountability and transparency, and promote stability, security and confidence in the financial system.
[3] Bank for International Settlements-BIS. (2012). "Principles for the Supervision of Financial Conglomerates". Available in: http://www.bis.org/publ/joint29.pdf

CFCs have expanded may have an impact in the Colombian foreign exchange market. This poses a new challenge to take into account into the target level of international reserves. Moreover, despite the FSC's accomplishments, agreements have not granted *Banco de la República* access to the host economies' financial data.

b. Macroeconomic challenges

In addition to the regulatory challenges, there are further challenges related to the economic performance of the countries where CFCs operate. Latin American economies are small and open, and individually do not affect international prices of goods, services or global assets. There are important differences in their sizes, production structures, monetary and exchange rate regimes, and trading partners.

Central American and Caribbean economies are characterized by their small sizes, by the fact that they are net importers of commodities (especially energy and food), their fixed, semi-fixed or dollarized exchange rate regimes, and their strong trade ties with the U.S.. Looking ahead, a recovery of U.S. growth would directly and positively impact output growth in these countries. At the same time, their exchange rate regimes imply that eventual increases in U.S. interest rates would induce similar movements of their interest rates. Moreover, higher global interest rates could increase the price of financing, which is concerning due to the elevated levels of external deficits.

In the event of an increase in interest rates financial systems in the region may face some tension because external and internal financing becomes more expensive. The quality of some loans granted in the presence of low interest rates may deteriorate under these new circumstances. Therefore, it is important to act preventively to contain excesses and unjustified credit lending. The use of macro-prudential policy is an alternative that could be implemented, especially in countries with less monetary autonomy.

The rising cost of financing may have additional adverse effects on the public finances of heavily indebted countries. In some cases the correction of risk premiums could be steep if debt sustainability is put into question. In more extreme situations, depreciation expectations could put undue stress on exchange rate regimes. In this sense, it is convenient to introduce structural fiscal adjustments where needed before the cost of external financing rises and while markets still provide room for maneuver.

There are other challenges, which are no less important but are sometimes less monitored. Among others, they refer to the ability to integrate different cultures into a financial conglomerate, the requirements to standardize the technology and information programs that allow proper and timely management of entities, the feasibility of establishing a brand, and the capacity to provide efficient and competitive goods and services given the knowledge and expertise achieved in different markets.

4. <u>Conclusions</u>

- CFCs have expanded in recent years to Central America and other Latin American countries. These expansions have been reflected in a higher number of subsidiaries and increased external assets of conglomerates.

- The expansions of Colombian banks abroad can be explained by both pull and push factors. First of all, the deterioration and deleveraging of banks from advanced economies opened the field for greater participation of banks from emerging economies in the region. Second, the strength and broad access of Colombian banks to international financial markets enabled them to spread overseas.

- The expansions of CFCs abroad have benefits for the Colombian economy and financial system. The Colombian economy and the new host regions are subject to different shocks or respond differently to common shocks. As a result, there is an increased diversification of macroeconomic and financial risks stemming from the investments of CFCs in the region. Nevertheless, in order to reap those benefits, Colombian authorities must overcome some regulatory and macroeconomic challenges.