Does Foreign Ownership Contribute to Sounder Banks in Emerging Markets? The Latin American Experience

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Abstract

Foreign bank entrants into emerging markets are usually thought to improve the condition and performance of acquired institutions, and more generally to enhance local financial stability. We use bank-specific data for a range of Latin American countries since the mid-1990s to address elements of this claim. Across the seven largest countries, we find that the financial strength ratings of local banks acquired by foreign entities generally show slight improvement relative to their domestic counterparts. Our more in-depth case studies of Chile, Colombia, and Argentina do not indicate striking differences in health between larger foreign and domestic retail-oriented banks (although state banks are noticeably weaker). However, foreign banks often had higher average loan growth, higher average provisioning expense, and greater loss-absorption capacity. These results suggest that foreign ownership may provide important positive influences on the stability and development of emerging market banking systems.

JEL codes: F3, F4

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I. Introduction

Over the latter half of the 1990's, foreign banks significantly increased their ownership shares of emerging market banking systems. This trend reflects a range of factors, perhaps most notably the need for recapitalization of local banking sectors in the wake of crises, but also broader market trends of consolidation, integration, privatization, and liberalization. Increased foreign ownership of emerging market banking systems is particularly striking in Latin America and Eastern Europe, where foreign banks now account for 50 percent or more of system assets in a number of countries. These structural changes could portend significant implications for domestic financial intermediation.

Empirical analysis of the effects of broad foreign participation in emerging market banking systems has been relatively limited, however, in part reflecting the recent timing of these developments. One direction of recent analysis has focused on the systemic bank efficiency effects associated with the entry of foreign banks, which generally provide increased competition for domestic banking institutions. In the Latin American context, Martinez-Peria and Schmukler (1999) have concluded that foreign bank entry has been associated with both lowered profit margins and increased efficiency of local banks.[1]

A second line of analysis considers differences in lending patterns across domestically owned and foreign-owned banks operating within emerging markets. In a study of Argentina and Mexico, Dages, Goldberg and Kinney (2000) show that private foreign banks and private domestic banks had similar lending activities over the 1990s, especially when financial condition was comparable. Foreign banks tended to show stronger and less volatile loan growth, potentially reflecting a more diversified funding base. These findings of foreign banks as relatively stable lenders to emerging markets are further supported by recent analysis of the behavior of international claims by individual U.S. banks (Goldberg 2001). These banks have not been particularly volatile lenders with respect to emerging markets. Indeed, the international claims of U.S. banks generally are considerably more sensitive to U.S. macroeconomic fundamentals than to emerging market fundamentals. Similar types of conclusions on lending are expressed in Peek and Rosengren (2000) and Palmer (2000), who find that foreign bank lending to Latin America was not characterized by "cutting and running"

[1] See related analyses by Burdisso, D'Amato, and Molinari (1998); Claessens, Demirguc-Kunt, and Huizinga (1998); and Clarke, Cull, D'Amato, and Molinari (1999).

during recent crises in emerging markets, although cross-border claims declined relative to local claims.

Whether broader strategic and operational differences exist across foreign and domestically owned banks in emerging markets remain open issues. In this paper, we review whether there are discernable differences between foreign and domestic bank condition and performance.[2] We focus on trends in Latin banks over the latter 1990's, a period characterized by substantial foreign presence but also some cases of significant macroeconomic stress. Our approach is more of an analytical review of relative changes in bank condition than an evaluation of the impact of foreign bank entry on the condition of domestic banks.

After briefly reviewing trends in foreign bank ownership in Latin America, we undertake two related analyses using annual data for the mid-1990s through 2001. First, we examine a broad indicator of institution strength, Moody's Bank Financial Strength Ratings (BFSRs), for three categories of banks (foreign, private domestic, and government) in seven countries: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. Second, for three countries – Chile, Colombia, and Argentina – we examine detailed data drawn from individual bank balance sheets to more finely compare specific aspects of bank condition (i.e., capital adequacy, asset quality, earnings and liquidity) across types of banks during recent periods of financial stress. Our analysis focuses entirely on retail-oriented banks.

We conclude that there are not systematic differences in the condition or performance of foreign banks versus their privately-owned domestic counterparts in the countries examined, although both are generally superior to government-owned entities. However, on the broad measure of financial strength ratings, there is some evidence that local banks acquired by foreign entities fared marginally better than those institutions that remained under domestic control. Our more detailed evaluation of bank condition in three countries yields more interesting results. Foreign banks, particularly those with longer-standing in-country operations, on average had consistently stronger loan growth than domestic private banks. Foreign banks established through recent acquisitions show more defensive actions and the lowest loan and deposit growth rates. We observe more aggressive loan provisioning and higher loan recovery rates by foreign banks across-the-board. Their more proactive recognition of losses has adversely affected foreign banks' profitability indicators, although risk-based capital ratios at

foreign banks remain above those of private domestic banks. These tendencies may indicate that foreign banks are more willing to tolerate, or can better afford, lower returns in the near term for the sake of building longer-term institutional strength. We further observe that foreign banks have tended to maintain greater asset liquidity and have relied less on deposit financing.

The lack of strong differences in foreign and domestic private bank condition may suggest there is competitive space for both types of institutions, and may reflect efforts in the three countries to improve supervision and regulation, promote increased consolidation, and progressively weed out the weakest players. Specific findings on foreign bank behavior, namely stronger credit growth, more aggressive provisioning behavior, and higher loss-absorption capacity, suggest that foreign ownership can impart important stabilizing influences on domestic banking systems in emerging markets.

II. Trends in Foreign Bank Ownership in Latin America

Prior to the 1990's, very few foreign banks were present in Latin America, and foreign ownership shares of domestic financial systems were low, reflecting a generally closed regulatory environment toward foreign investment in the sector. Domestic financial systems were also generally fragmented, composed of a large number of financial institutions (including a number of marginal players) and a substantial state bank presence at the federal and regional levels.

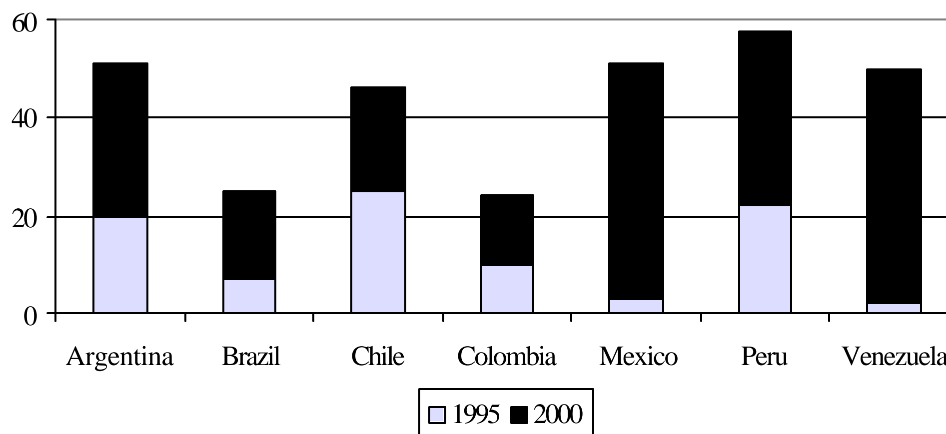
Generally beginning in the wake of a series of banking crises in the mid-1990's, attitudes toward foreign participation in domestic financial sectors evidenced a dramatic shift. Pressed by the need for substantial recapitalization of a number of institutions, and the need for structural consolidation and rationalization of the state sector, regulatory limitations on foreign bank ownership were significantly liberalized. The sale of intervened institutions, privatizations of state banks, and some recapitalization efforts of remaining banks triggered a substantial increase in foreign bank ownership levels in regional financial institutions.

Large-scale acquisitions began in 1995, with foreign banks acquiring controlling stakes in a number of the region's largest private banks, particularly those with a strong national or regional retail franchise. As a result, the structure of bank ownership in Latin America has changed dramatically over the past five years, with foreign banks now controlling majority

[2] Banks are considered to be foreign if majority owned by foreign shareholders, or if foreign shareholders exercise

shares in nearly all of the larger Latin financial systems, with the important exceptions of Brazil and Colombia (See Chart 1).[3]

Chart 1: Foreign Share of Latin Banking System Assets
(Percent of System Assets, 1995 and 2000)



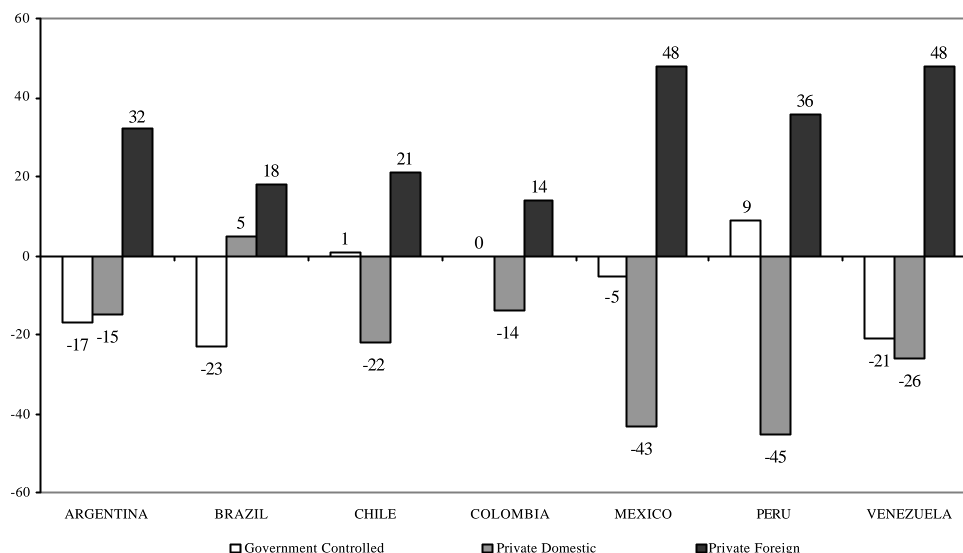
This increasing foreign bank presence has reduced both domestic private and public ownership shares throughout the region. As shown in Chart 2, in Chile, Colombia, Mexico and Peru, foreign entry largely displaced private domestic banks. In other countries where public sector banks have historically played a more significant role in the credit intermediation process, such as in Brazil, foreign entry has coincided with large-scale privatization efforts. In countries like Argentina and Venezuela, foreign banks have increased market share via both significant privatizations of state assets and through the purchase of sizeable domestic banks from private shareholders.

effective management control.

[3] As shown by Peek and Rosengren (2000), data on local exposures of foreign banks understates overall exposures due to the presence of direct cross-border lending.

Chart 2: Change in Asset Ownership Share of Banking in Latin America

(Percent of System Assets, 1995 and 2000)



Liberalization of foreign entry and a renewed commitment to privatizing inefficient public sector banks were only two components of broader financial sector reforms undertaken in the region in the latter half of the 1990's. In a number of countries, these structural reforms were bolstered by the introduction of deposit insurance, the liquidation or consolidation of nonviable entities, and the dedication of substantial resources to strengthening supervisory oversight and the regulatory framework. A number of measures were implemented to enhance prudential supervision and regulation, including the establishment of higher capital requirements, more stringent loan classification and provisioning standards, and increased disclosure requirements.

In combination, during the second half of the 1990's there was a dramatic transformation of regional financial systems. The domestic banking environment has undergone a marked consolidation and a significant change in the competitive landscape. Since many of these changes are relatively recent, the full effects of this transformation may not yet be evident. Moreover, recent episodes of weak macroeconomic conditions have placed additional pressures on bank balance sheets, limiting lending activities, and potentially constraining

observed differences between foreign and domestic banks. The initial strength of market participants and their capacity to respond to heightened competition will be important determinants of the future evolution of domestic financial systems.

III. Financial Institution Strength

Financial institution strength is usually thought of in quantitative terms, namely a bank's intrinsic financial condition, reflecting its capital, reserves, asset quality, earnings and liquidity, as well as in qualitative terms, reflecting the underlying quality and effectiveness of bank management, internal controls, and risk management policies and practices. Financial institution soundness is founded on both a strong balance sheet and strong management, and significant deficiencies in either element generally suggest medium-term vulnerability.

A. The CAMEL Framework. The intrinsic strength of a bank is usually evaluated based on a CAMEL framework, consisting of individual assessments of core aspects of a bank's financial condition and performance: **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, and **L**iquidity. This framework is sometimes modified to include other aspects of a bank's condition or performance, such as the CAMELS framework employed by federal and state bank regulatory agencies in the United States, which also evaluates a bank's **S**ensitivity to market risk. Other frameworks, such as CAMELOT, include individual components for assessments of **O**perational controls and **T**echnology.[4] Under such frameworks, individual components are typically evaluated on a rating scale. These individual ratings are then aggregated to arrive at a composite ranking of the institution, which usually reflects differential emphasis on individual components, and not a simple average. Box 1 provides an abbreviated summary of factors that are considered in undertaking a CAMEL analysis.

[4] Related issues are covered in Barth, Caprio and Levine (2001), along with a discussion of a new country-specific database on regulation and supervision of banks around the world.

Box 1: CAMEL Ratings		
	Components of Ratings	Possible Implications of Foreign Ownership
Capital Adequacy	Compliance with regulatory standards; Adequacy given nature/level of risks, and future expansion plans; Quality of bank capital.	Improved access to and increased diversification of bank capital, leading to stronger and more stable capital levels.
Asset Quality	Creditworthiness of bank loans and investments; Adequacy of credit policies and procedures; Adequacy of loan loss reserve policies and levels; Level of impaired assets to capital and reserves.	Improved credit underwriting and administration leading to lower non-performing loan levels and higher reserve coverage of NPLs.
Management	Fitness and experience levels; Adequacy of strategic and operating plans; Risk management and control environment; Succession planning.	Secondment of management from head office, coupled with risk management and internal control practices closer to international norms, leads to better corporate governance.
Earnings	Quantity and quality; Diversification; Sensitivity to market risk.	Wider variety of products and services, stronger corporate governance, and potentially lower funding costs, leads to higher and more stable bank earnings.
Liquidity	Adequacy of asset/liability management policies and procedures; Appropriate level of asset and liability liquidity; Diversification of funding sources; Contingent funding plans.	Foreign bank access to parent bank liquidity and international funding markets, in combination with a higher credit standing of the parent and more sophisticated balance sheet management techniques, leads to better liquidity management.

Foreign ownership of domestic banks in emerging markets generally is argued to increase overall financial institution strength in both quantitative and qualitative terms. Foreign banks are viewed as providing greater access to capital and liquidity and bolstering balance sheet strength. The knowledge, skill, and technology transfer that accompany foreign bank entry is expected to contribute to a stronger control and risk management environment. More

broadly, foreign bank presence in emerging market financial systems is argued to contribute to an improved financial system infrastructure by encouraging higher standards in auditing, accounting and disclosure, credit risk underwriting and reserving, and supervision.

However, the altered competitive environment may cause pressures on domestically owned banks, as documented in Martinez-Peria and Schmukler (1999). If foreign banks "cherry-pick" the lower risk clientele from the domestic banks, the overall asset quality and earnings of domestic banks could decline. The implications for domestic bank financial strength presumably will depend on initial conditions, the overall regulatory environment, and the extent to which domestic banks take measures to retain competitiveness.

We now turn to the data to undertake an analysis of whether there are significant differences between domestic and foreign banks in Latin America on a number of indicators of bank balance sheet strength. We first analyze differences using ratings of institutional strength provided by Moody's and then assess possible differences according to a CAMEL-based framework.

B. Quantitative Differences in Financial Condition between Domestic and Foreign Banks in Latin America. One broad indicator of the soundness of a bank is its Moody's Bank Financial Strength Rating ("BFSR"). BFSRs reflect Moody's evaluation of the intrinsic financial strength of a bank on a scale of A-E, with A representing the highest rating, without regard for prospective parent or government support.[5] The exclusion of support is useful for our purposes in that the BFSR better compares the basic health of domestic and foreign banks: it filters out possible support of domestic banks by the government or support of foreign banks by the parent. Moreover, BFSRs are viewed as providing a relatively uniform metric over time.

One of the main limitations of BFSRs as a metric of soundness is their timeliness. Ratings may adjust with a lag to changes in underlying institutional condition reflecting the administrative process in assigning or revising ratings. Additionally, BFSRs cover only a subset of banks in a given country (although they tend to include the largest institutions). Lastly, BFSRs only indicate the general health of an institution, and do not identify specific areas of strength or weakness (capital, asset quality, etc.)

[5] Ratings categories are defined by Moody's as follows: A ("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.

Table 1 shows the average asset-weighted BFSRs for rated foreign and domestic banks (67) from seven Latin American countries. A comparison of 1995 with 2001 shows that the average ratings declined for 4 countries (Argentina, Colombia, Peru and Venezuela), improved for 1 country (Brazil), and either fluctuated or remained unchanged for the other 2 countries (Mexico and Chile). Historically, no Latin American bank has been rated higher than a C+ (considered by Moody's as "good") largely due to broad environmental vulnerabilities, particularly in the underlying economies and legal and regulatory infrastructures.

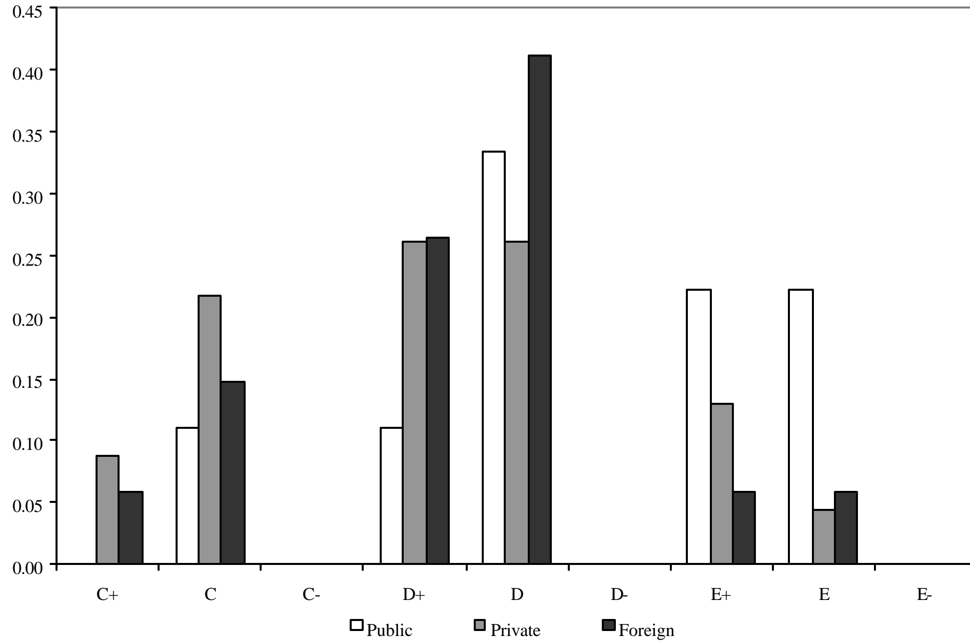
Table 1: Asset-weighted Average BFSR Ratings

Country	% Assets Rated	1995	1996	1997	1998	1999	2000	2001
Argentina	57	D+	D+	D+	D+	D	D	D
Brazil	69	n.a.	D	D	D+	D	D+	D+
Chile	83	C	C	C	C	C	C	C
Colombia	33	C	C-	C-	C-	D+	D	D
Mexico	75	D+	D	D-	D-	D-	D	D
Peru	69	n.a.	n.a.	C-	C-	D+	D	D
Venezuela	64	D+	D+	D+	D	D	D	D

Source: Authors' calculations using Moody's asset and ratings data

Chart 3 breaks out the current average BFSR ratings across ownership categories. Public bank ratings are clearly skewed toward the lower end of the rating scale, while foreign banks have the highest proportion of ratings in the D or higher range.

Chart 3: Share of Rated Banks by BFSR Values, 2001



These data are useful for comparing ratings changes of foreign and domestic banks over time. Since a large number of rated banks (28 out of 67) were acquired by foreigners between 1995 and 2001, we have an opportunity to consider the evolution of the ratings of these banks, both in an absolute sense and relative to other banks at similar points in time.

Since banks were acquired at different dates, we date the acquisition year as T=0 and consider the rating changes observed within 1, 2, 3, 4, or 5 years after the acquisition event. We first analyze the path of actual changes in ratings in the aftermath of foreign acquisition of a domestic bank. We then generate a measure of relative ratings changes, where we adjust the ratings changes of a bank for country and year effects that influence all other banks within a country. For example, the relative ratings changes of an Argentine bank acquired in 1997 are the actual ratings changes for that bank in each year through 2001, net of an (unweighted) average of the ratings changes of all Argentine banks rated in 1997, and considered a "comparable" cohort of institutions.

We compute these ratings paths for banks in each country, and also compute an average across countries (unweighted by bank or country size) of the relative ratings changes of acquired banks. The main patterns of ratings results averaged across banks in all seven countries are captured by the cross-country summaries shown in Figure 1, Panels A and B. Each unit on

the vertical axis represents a single ratings notch, for example a move from D to D+ or from C- to C. The dots in the figures represent the average ratings change across all foreign-acquired banks at each of their post-acquisition years. The vertical dashes extending above and below these dots are the minimum and maximum ratings changes observed for any bank at the specified year after acquisition. The right-most entry in these figures, denoted by "Cumulative", represents the average of total changes in ratings for acquired banks across their entire post-acquisition history.[6]

Figure 1 Panel A shows that the actual rating changes of acquired banks either have been positive and as high as 3 notches or nonexistent within one year of acquisition. Observe that the average change in bank ratings in the first post-acquisition year is a small positive number, reflecting the fact that very few acquired banks had any immediate change in their ratings. Similarly, mean ratings changes were close to zero in all subsequent years, though in years 2 and 3 after acquisition there were isolated cases of acquired bank upgrades or downgrades.[7] The "cumulative" entry shows the range of total ratings changes of the acquired banks in their entire post-acquisition histories. The basic lesson is that the ratings changes of domestic banks purchased by foreign banks were, more often than not, zero.

[6] "Cumulative" does not reflect the sum of the dots in the individual year entries in the rest of the figure. Rather, it is the average of the summed ratings changes of banks over the distinct horizons in their post-acquisition histories.

[7] In Argentina, two of the acquired banks that were rated had downgrades, while the other 4 banks had no ratings changes in the period since acquisition. In Brazil, seven of the nine acquisitions (all since 1997) had no ratings changes, while the other two banks had upgrades of one and three grades, respectively. In Mexico, the three acquired banks all experienced upgrades within one year of acquisition.

Figure 1 Panel A: Changes in Acquired Bank BFSRs, All Countries

where T= year of acquisition

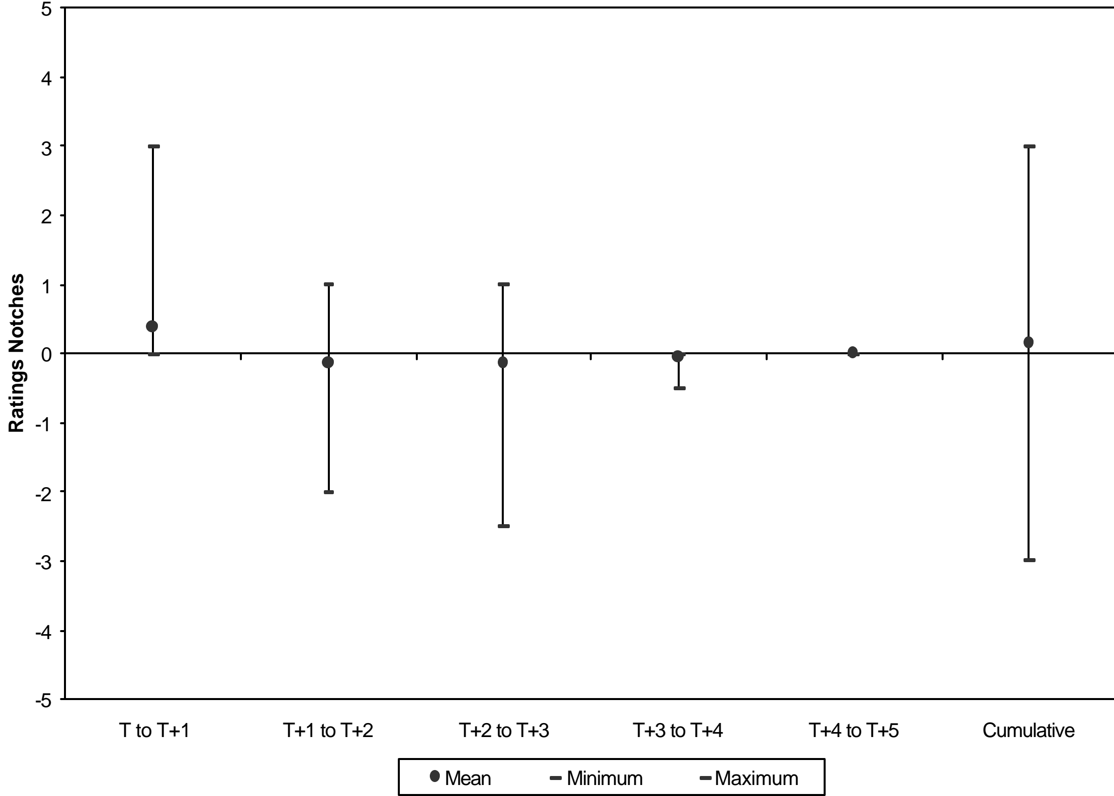
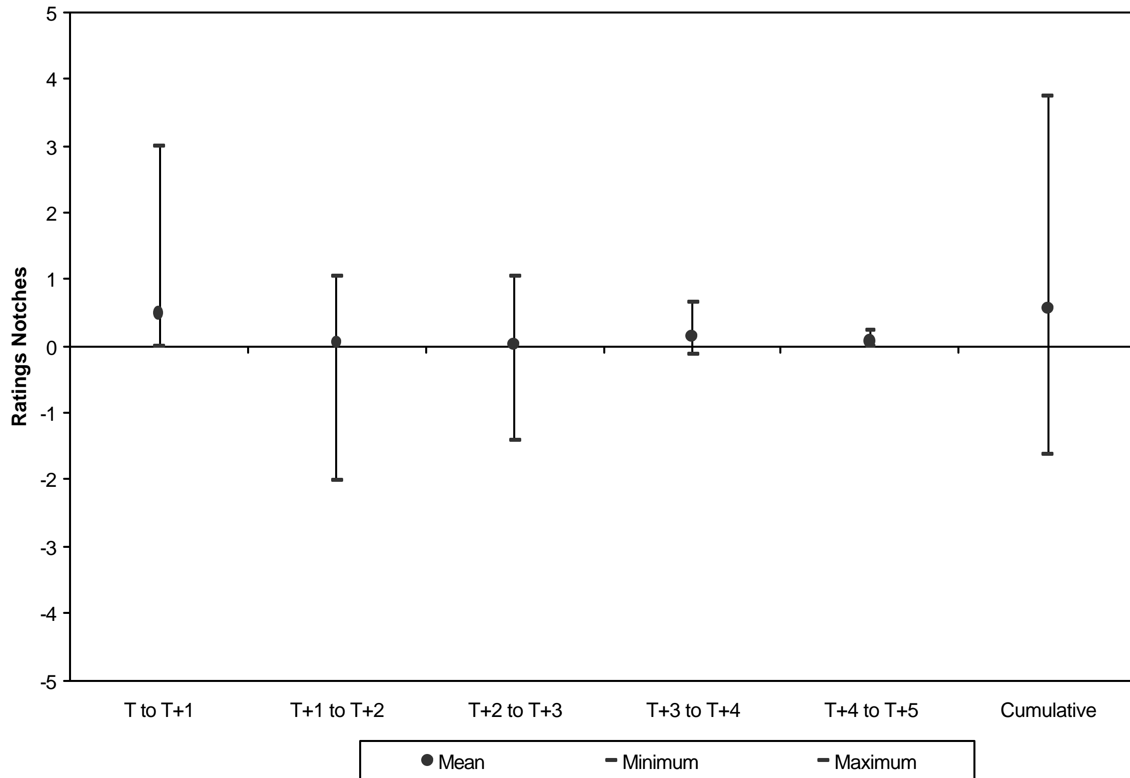


Figure 1 Panel B: Changes in Acquired Bank BFSRs Relative to Domestic Bank BFSRs, All Countries

where T= year of acquisition



Panel B of Figure 1 shows that foreign acquired banks performed modestly better than domestic banks, with most of the relative gains soon after the initial acquisition. This difference between Panel A and Panel B results arises because domestic banks tended to be downgraded while the foreign banks had more stable ratings. Across all countries, the cumulative difference in bank ratings was typically less than a single ratings notch. The magnitude of this relative improvement is similar for foreign bank ratings changes compared with only the private subset of domestic banks.

There were, of course, some differences in the ratings experiences of banks within individual countries. As shown in Table 2, the relative ratings improvements of foreign banks were particularly strong in Peru, Chile and Mexico, with small relative improvements for foreign banks in Brazil and Venezuela. The actual and relative ratings changes were negative for Argentina and Colombia. However, these negative results may understate the relative gains of the foreign rated banks. Foreign banks are being compared with the domestic banks that remained in operation (and were rated) in the latter half of the 1990s through 2001. Many of the

weaker domestic banks were unrated and some closed or changed ownership status during this period, biasing the empirical results against foreign banks in these countries.

Table 2: Cumulative BFSR Changes for Foreign-Acquired Banks

	Actual Changes	Foreign-Acquired Relative to all Domestic Banks	Foreign-Acquired Relative to Domestic Private Banks
All Countries	0.15	0.56	0.50
Argentina	-0.67	-0.33	-0.67
Brazil	0.44	0.63	0.66
Chile	1.00	1.61	1.71
Colombia	-3.00	-0.75	-1.00
Mexico	1.67	1.36	1.36
Peru	0.00	1.75	1.75
Venezuela	-0.25	0.38	0.38

Source: Authors' calculations using Moody's BFSR data.

C. Bank Performance by CAMEL Components. In this section, we analyze in more detail the financial condition of foreign and domestic banks within a CAMEL-based approach. Specific Latin American countries are selected based on three criteria: a sufficient mixture of foreign and domestically owned banks, a recent period of stress on the banking system, and data availability. Three countries and time frames satisfy these criteria: Chile, Colombia, and Argentina during the post-1997 period.

For each country, we use publicly available institution-specific data from supervisory authorities and rating agencies to calculate specific indicators of bank condition and performance across three broad categories of bank ownership: foreign, domestic private and government. We also evaluate trends in these indicators across two subsets of foreign ownership: banks which have been acquired by foreign shareholders relatively recently (since 1995), and foreign banks which have maintained significant local operations for a more extended period of time. We compare these foreign banks to the local banks that have remained under domestic control.

Our analysis focuses on the 25-30 largest banks operating in each country, covering between 80 to virtually 100 percent of banking system assets in the respective countries. Since we are primarily interested in evaluating commercial banks, we exclude from this sample

institutions not actively engaged in the retail banking market (those banks with deposits and/or loans representing less than 25 percent of assets); very small banks (defined as accounting for less than 1 percent of sample loans); and other financial institutions with unique charters and operational characteristics (such as credit cooperatives, national mortgage banks, consumer finance companies and non-banks).

Our analysis uses unweighted averages within and across bank ownership categories to better evaluate the effects of foreign ownership at the institutional level. As such, results should not be interpreted as precise indicators of the level or trend of overall banking sector condition and performance. Moreover, bank financial results are prepared in accordance with local accounting and regulatory standards and therefore are not necessarily comparable internationally or across the three countries. Individual banks or ownership types may also apply existing standards more or less rigorously.

The Chilean Experience. Following a period of crisis in the early 1980's, the condition and performance of Chile's financial sector has substantially improved on the back of enhanced regulatory and supervisory oversight, and sustained economic growth and relative stability. As a result, bank penetration is the highest within Latin America – credit to the private sector represents almost 70 percent of GDP – and the sector is considered one of the soundest within the region. However, the effects of the crisis lingered well into the 1990's, particularly in the form of large dividend payments to the central bank to service bailout costs.[8]

The mid-1990's witnessed a period of escalating bank penetration, consolidation and foreign entry. Real deposit and loan growth rates averaged above 10 percent annually, with banks increasingly focused on the consumer segment where loan growth peaked at an annual rate above 30 percent in 1996. A series of mergers and acquisitions have concentrated bank ownership and the top 5 banks now control 60 percent of bank assets, compared to 45 percent in 1995.

Although foreign banks have historically maintained more of a presence in Chile than in the rest of the region – controlling 25 percent of bank assets in 1995 – penetration accelerated in the later 1990's with Spanish Banco Santander's (BSCH) purchase of fifth-largest Osorno y La Union in 1996, and the subsequent acquisition of second-largest Banco Santiago from the

[8] For the most part, these debts have since been settled at substantial discounts to face value.

Luksic group in the wake of its 1999 merger with Central Hispanoamericano. Also during this time period, Bhif was acquired by Spain's Banco Bilbao Vizcaya Argentaria (BBVA), and Sud Americano by Canada's Scotiabank. These acquisitions, combined with organic growth, have essentially doubled foreign participation in the Chilean financial sector over the past 5 years to just under 50 percent. Roughly two-thirds of this foreign presence is attributable to Spanish banks, and one-quarter to U.S. and Canadian institutions.

With the onset of the crisis in Asia (the destination of one-third of Chile's exports), historical lows for copper prices, and the adverse effects of El Niño on energy and agricultural sectors, the Chilean economy began slowing in 1998. A deterioration in global liquidity conditions following the Russian financial crisis and sharp domestic monetary tightening to support the peso further contributed to economic deceleration, with recession setting in by year-end 1998. These events adversely affected the operating environment and performance of Chile's banks. Although real GDP growth recovered in 2000, domestic demand and investment growth remain weak by historical standards, and banks have yet to evidence a recovery in credit activity. Below we evaluate the condition and performance of Chilean banks across ownership categories throughout this recent period.[9]

The Sample of Chilean Banks. The Chilean banks that we evaluate account for virtually 100 percent of system assets. The number of foreign-controlled entities ranges from 13 to 15, representing 21 to 48 percent of sample assets in any given year. Of these, up to ten (4.5 percent of system assets) have been excluded because of business orientation and/or size. Of the remaining foreign banks in our sample, four are considered to be recent acquisitions (since 1995), equivalent to almost 40% of sample assets, and three have maintained local operations for an extended period of time (approximately 10% of sample assets).

Among domestic banks, the number privately owned ranges from 9 to 11 (38 to 64 percent of sample assets). In any given year, at most two institutions accounting for 0.6 percent of sample assets are excluded due to business orientation or size. There is one government-owned bank – Banco del Estado – operating in Chile. Over the sample period, this bank has consistently ranked second in asset size and its share of sample assets has declined only slightly

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[9] The statistics discussed in this section are compiled using a variety of sources, including the Chilean banking superintendency and Moody's.

from 15.2 to 13.6 percent. By virtue of its unique mission to provide financing to under-serviced sectors, Estado is largely excluded from the following analysis.

Balance Sheet Structure and Liquidity. Foreign banks in Chile, on average, tend to rely less on deposits for funding, maintain a higher capital cushion, and dedicate a greater proportion of assets to lower-risk, liquid investments (Table 3, Panel A). Relative to privately held domestic banks in particular, foreign banks dedicate significantly less of their balance sheet to lending activities. However, these behaviors may still be evolving. In particular, foreign banks appear to have aggressively targeted growth in deposit market share, as evidenced by an average annual growth rate of 31 percent over the sample period – significantly higher than domestic private or public banks (Table 3, Panel C).[10] Furthermore, foreign bank holdings of relatively lower-cost demand deposits are in line with those of private domestic counterparts (Table 3, Panel A). Foreign banks, on average, have also increased loan portfolios marginally faster than domestic banks over the sample period – although substantially less than deposits, leading to enhanced liquidity. Via both acquisitions and organic growth, foreign banks' share of sample deposits and loans grew to just over 40 percent in 2000, from less than 20 percent in 1997.

[10] Note that average growth rates are in nominal terms and adjust for acquisition effects during the sample period.

Table 3: Summary Balance Sheet Structure of Chilean Banks
(as a percent of assets)

Panel A	Liquid Assets		Loans			
Assets	1997	2000	1997	2000		
Foreign	34	33	67	61		
Domestic Private	24	25	79	73		
Government	40	34	60	59		
	Total Deposits				Capital	
			of which: Demand			
Liabilities	1997	2000	1997	2000	1997	2000
Foreign	39	45	11	14	11	8
Domestic Private	54	53	14	14	6	7
Government	61	55	21	18	6	5

Panel B	Liquid Assets		Loans			
Assets	1997	2000	1997	2000		
Recent Foreign Acquisitions	19	28	83	67		
Existing Foreign	38	38	62	54		
Domestic Private	26	25	77	73		
	Total Deposits				Capital	
			of which: Demand			
Liabilities	1997	2000	1997	2000	1997	2000
Recent Foreign Acquisitions	51	45	14	14	7	7
Existing Foreign	34	44	10	14	12	10
Domestic Private	56	53	15	14	6	7

Loan and Deposit Trends
(1997 through 2000, in percent)

	Average Annual Loan Growth	Average Annual Deposit Growth	Loans / Deposits 1997	Loans / Deposits 2000
Panel C				
Foreign	14	31	176	137
Domestic Private	12	14	147	139
Government	13	9	98	108
Panel D				
Recent Foreign Acquisitions	3	6	163	148
Existing Foreign	29	64	186	122
Domestic Private	15	18	138	139

Source: Authors' calculations based on data from the Superintendencia de Bancos e Instituciones Financieras Chile

There are important differences in the balance sheet structure and liquidity trends across banks recently acquired by foreign shareholders, foreign banks which have been operating in Chile for an extended period of time, and domestically-owned banks over this time period. Banks acquired over the past five years had, on average, a much sharper shift in the asset mix away from loans and toward more liquid holdings (Table 3, Panel B). At the same time, these acquired banks reduced their reliance on deposit-based financing, while other foreign banks long active in the Chilean market sharply expanded deposit share. These distinct behaviors are clearly evident in Charts 4 and 5, Panels B, where average deposit and loan growth rates below 7 percent contrast with much higher rates for longer present foreign banks, as well as the more moderate growth of private domestic entities.

Chart 4: Average Loan Growth

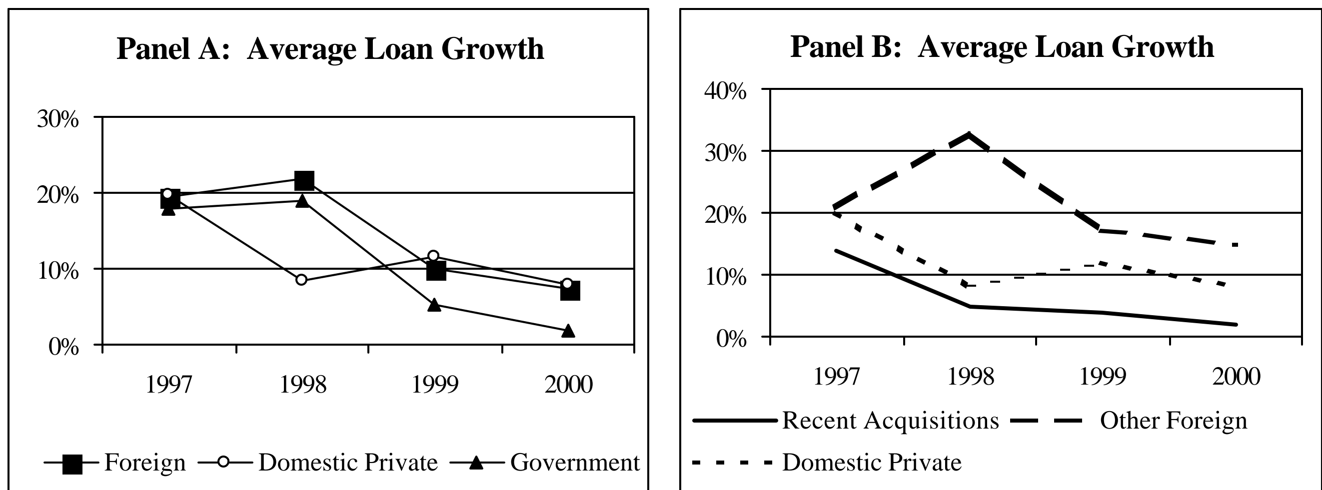
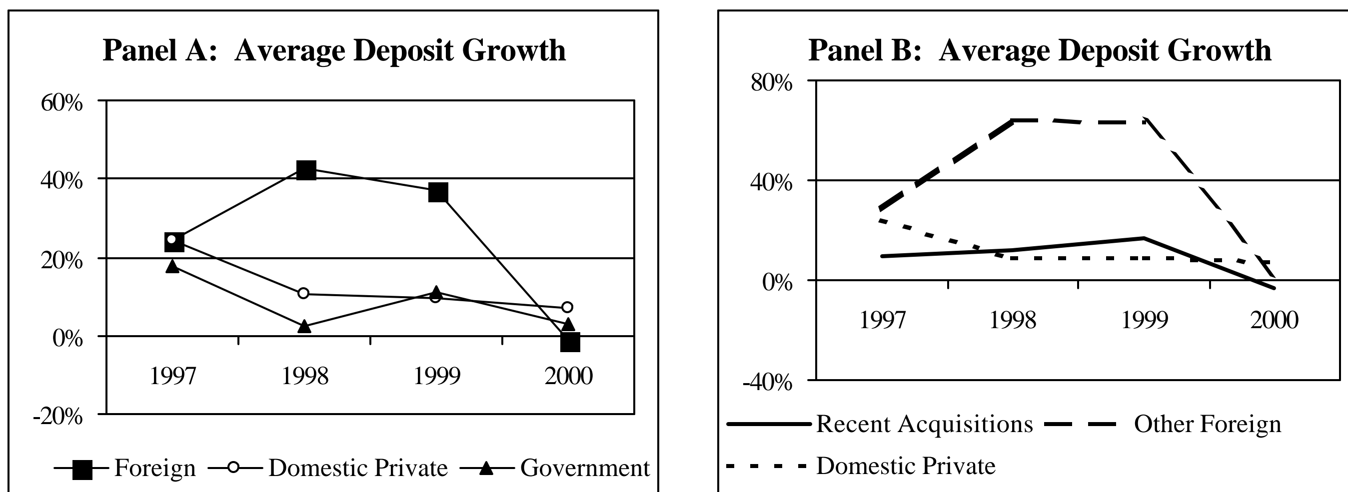


Chart 5: Average Deposit Growth



These results are consistent with an inward management focus in the wake of large-scale acquisitions, as attention turns toward merger integration and absorption issues such as standardizing risk management and operating procedures, and integrating technology platforms and management information systems. The run-off in loans as a proportion of average assets would also be consistent with post-acquisition balance sheet cleansing. These findings also suggest that foreign banks that rely primarily on organic growth may feel the pressure to build market share and respond aggressively to industry consolidations.

Asset Quality. Over the sample period, there was deterioration in asset quality as the stock of sample non-performing loans (NPLs) more than doubled in nominal terms. However, NPLs as a share of loans remain broadly manageable at, on average, just under 2 percent of sample loans.[11] Furthermore, credit portfolio deterioration at private sector banks appears to have proceeded at a similar pace, regardless of bank ownership (Table 4, Panel A). Grouping banks into peer groups with similar market orientation and penetration yields similar results, suggesting broad based deterioration across borrowers.

[11] It is important to note that Chilean banks do not report as non-performing the full balance of loans past-due – defined as at least 90 days delinquent on payment of principal or interest. Reported NPLs include only the payments that are actually overdue, unless legal restitution has been initiated for the entire balance.

Table 4: Selected Asset Quality Indicators of Chilean Banks								
Panel A	% of Loans						% of NPLs	
	NPLs		Provisions		Recoveries		Loan Loss Reserves	
	1997	2000	1997	2000	1997	2000	1997	2000
Foreign	0.7	1.9	0.9	1.9	0.2	0.7	216	181
Domestic Private	0.8	2.0	0.9	1.4	0.2	0.2	156	192
Government	2.2	1.3	1.1	1.1	0.6	0.6	101	159
Panel B								
Recent Foreign Acquisitions	1.0	2.3	1.2	1.6	0.3	0.5	125	126
Existing Foreign	0.6	1.5	0.7	2.3	0.1	1.0	248	254
Domestic Private	0.7	2.0	0.8	1.4	0.2	0.2	168	192

Source: Authors' calculations based on data from the Superintendencia de Bancos e Instituciones Financieras Chile

However, institutions acquired by new foreign owners over the past five years had a somewhat stronger rate and level of asset quality deterioration (Table 4, Panel B). This may reflect either the purchase of banks of lesser health, or a more proactive management of credit risks. Of note, foreign banks with more established local operations maintained stronger asset quality ratios than domestic private banks during this economic downturn – possibly reflecting a more conservative loan orientation and/or credit risk management.

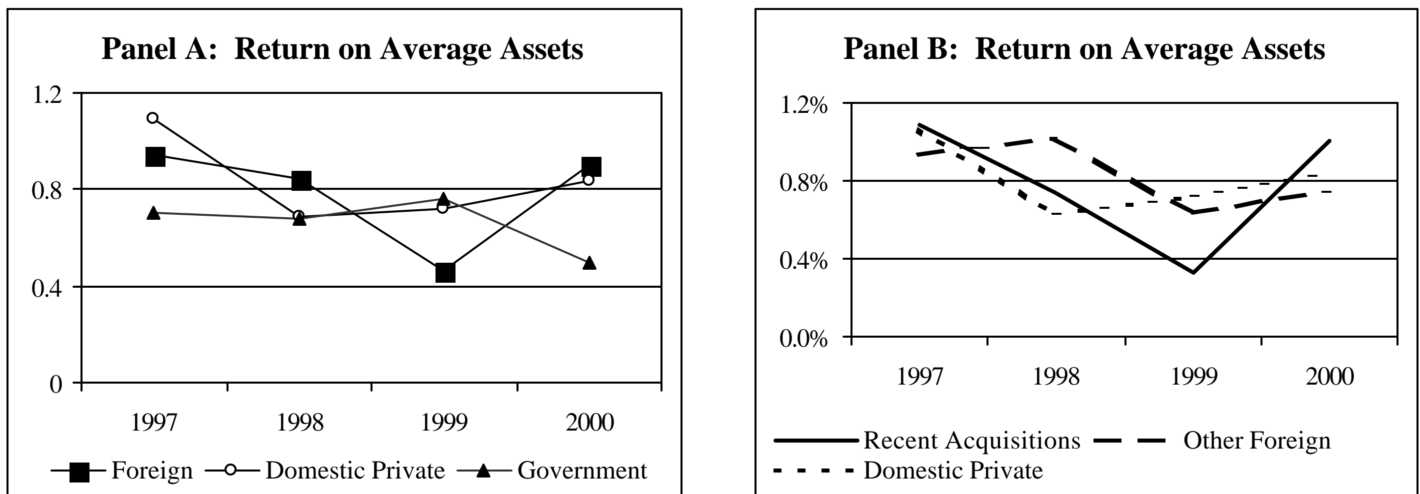
The fact that these established foreign banks were also the most aggressive provisioners for potential loan losses over the sample period further supports this argument. In general, both acquired and established foreign banks provisioned more heavily than their domestic counterparts. Perhaps a reflection of this activity, foreign banks – and in particular more established foreign banks – outperformed domestic peers in recovering losses. Over the sample period, foreign banks as a group recovered 1.8 percent of average loans – with longer-standing foreign banks recovering 3.8 percent – as compared to 0.8 percent for domestic private banks.

Banks across all ownership categories consistently maintained adequate reserves to cover potential losses embedded in reported NPLs – although foreign banks with longer-standing operations clearly stand out (Table 4, Panel B). A stable reserve trend, on average, at

recently acquired entities – despite rising provisioning activity – points toward a relatively more aggressive approach to charging off problem loans.[12]

Earnings. There is no clear trend in the overall profitability of either privately held domestic banks or foreign-controlled banks during the sample period. Both have experienced downturns, with domestic banks more rapidly exhibiting the effects of a deterioration in operating conditions (Chart 6, Panel A).

Chart 6: Return on Average Assets



Foreign bank profitability deteriorated more sharply from 1997-1999, but has since rebounded more quickly. This reflects higher provisioning expenses in the wake of acquisitions in 1998 and 1999, and may also reflect a higher volume of market-related activities (evident in operating income and expense ratios in Table 5, Panel A). Netting these effects out yields broadly similar operating income and expense ratios across banks.

[12] While we do not have institution-specific charge-off ratios for the sample set, a review of publicly released financial statements of a subset of the larger banks shows charge-offs as a proportion of average loans rising noticeably in the wake of foreign acquisitions.

Table 5: Selected Profitability Indicators for Chilean Banks
(as a percent of average assets)

Panel A

Income	Net Interest Income				Non-Interest Operating Income			
	1997	1998	1999	2000	1997	1998	1999	2000
Foreign	3.2	3.1	3.6	3.7	8.9	9.9	13.3	14.2
Domestic Private	3.3	3.5	3.4	3.7	3.2	4.4	3.6	4.3
Government	3.5	4.1	3.6	3.6	1.6	2.3	2.3	2.3

Expense	Provisions				Non-Interest Operating Expense			
	1997	1998	1999	2000	1997	1998	1999	2000
Foreign	0.66	1.25	1.90	1.21	10.6	10.6	15.2	16.1
Domestic Private	0.72	1.20	1.47	1.08	5.5	6.4	5.4	6.0
Government	0.67	1.00	0.83	0.70	4.5	4.9	4.8	4.5

Panel B

Income	Net Interest Income				Non-Interest Operating Income			
	1997	1998	1999	2000	1997	1998	1999	2000
Recent Foreign Acquisitions	3.8	3.8	3.5	3.5	5.8	7.5	6.2	10.3
Existing Foreign	2.9	2.7	3.7	4.0	10.3	13.5	22.9	19.4
Domestic Private	3.1	3.5	3.4	3.7	1.9	2.6	3.6	4.3

Expense	Provisions				Non-Interest Operating Expense			
	1997	1998	1999	2000	1997	1998	1999	2000
Recent Foreign Acquisitions	1.0	1.5	1.8	1.1	8.2	9.4	8.2	12.0
Existing Foreign	0.5	1.1	2.1	1.3	11.9	13.5	24.6	21.6
Domestic Private	0.6	1.1	1.5	1.1	4.2	4.6	5.4	6.0

Source: Authors' calculations based on data from the Superintendencia de Bancos e Instituciones Financieras Chile.

On average, banks that were recently acquired exhibited declining net interest margins, while those of longer-established foreign and domestic banks increased. This would be consistent with previously discussed loan and deposit growth trends. While all banks witnessed an increase in other operating revenues, this was particularly pronounced at foreign banks, although again, largely market driven with net operating income exhibiting broadly similar

trends. All banks also recorded net efficiency gains over the sample period, slightly more pronounced at recently acquired banks but not significantly.

Capital Adequacy. Foreign banks began the sample period with a higher ratio of capital to assets and, despite a moderate deterioration, remain broadly better capitalized than privately held domestic banks (Table 3, Panel A). Stronger capital ratios are, however, concentrated in the foreign banks with a longer-established local presence. Recently acquired banks exhibit similar capital levels as domestic banks, suggesting either that ownership changes were not accompanied by significant recapitalization, or that new capital has been used to effect balance sheet cleansing.

A similar trend is evident in the evolution of risk-based capital ratios over the sample period (Table 6). In aggregate, foreign banks have sharply stronger, albeit decreasing, Tier 1 and Total risk-based capital ratios than domestic banks – reflecting their relatively lower-risk balance sheet structures (Panel A). Again, stronger capital ratios are, on average, concentrated in those foreign banks which have been active in the local market for an extended period of time (Panel B).

Table 6: Risk-Based Capital Ratios
(percent of risk-weighted assets)

	Tier 1 Capital		Total Capital	
	1998	2000	1998	2000
Panel A				
Foreign	10.57	9.31	17.23	15.41
Private Domestic	6.27	6.67	10.29	11.14
Government	5.88	5.79	11.35	12.70
Panel B				
Recent Foreign Acquisitions	7.80	7.39	12.80	13.20
Existing Foreign	11.80	11.90	19.40	18.40
Domestic Private	6.06	6.67	9.90	11.14

Source: Superintendencia de Bancos e Instituciones Financieras Chile

The disparity between foreign and domestic capital ratios may be explained, in part, by constraints throughout the early 1990s on domestic bank capital generation due to high dividend payout ratios on subordinated debt inherited from the early 1980's crisis. In the wake of 1997 bank reform legislation that, among other things, adopted the 8 percent Basle risk-weighted capital standard, domestic banks have taken steps to boost capital adequacy levels. As a result, on average, privately owned domestic banks also comfortably exceed minimum regulatory standards for capital adequacy.

Overall Assessment. While Chile's financial sector as a whole appears to have weathered the recent economic downturn relatively well, without clear-cut distinctions in quality or trend across ownership types, there do appear to be important differences in operating behavior across domestic and foreign banks that could point toward longer-term institutional trends. These are particularly pronounced when we evaluate condition and performance across banks which were recently acquired by foreign entities, foreign banks which have been active in the local market for an extended period of time, and domestic private banks.

Overall, foreign banks, on average, rely less on deposit-based financing (although foreign banks not absorbed by merger integration issues appear to be trying to change this); dedicate less of their balance sheet to lending; reduce deposit and loan growth less as macroeconomic conditions deteriorate; provision – and possibly charge off – more aggressively for potential loan losses despite a similar degree of deterioration in NPL ratios; are more successful at recovering charged-off loans; maintain a deeper capital cushion; and appear more adept at diversifying revenue streams. There does not, however, appear to be evidence that foreign banks are in substantially overall sounder condition than their domestic counterparts, possibly reflecting a supervisory framework geared toward active monitoring of credit risks.

The Colombian Experience. As in the case of Chile, a banking crisis in the early 1980's would be a trigger for later structural and regulatory reforms that would significantly enhance the condition and performance of the Colombian banking system.[13] Beginning in the early 1990's, Colombia implemented a number of measures to increase competition and efficiency in the financial sector, as part of a broader program of economic liberalization and market reform.

[13] The statistics discussed in this section are compiled using a variety of sources, including the Colombian banking superintendent and Moody's.

These measures included, *inter alia*, interest rate liberalization, a reduction in barriers to entry in Colombia's historically segmented financial system, opening the sector to majority ownership of banks by foreign financial institutions, and a reduction in financial intermediation taxes (such as reserve requirements). These measures, coupled with strong domestic demand, contributed to rapid real credit growth (of more than 20 percent annually from 1993 to 1995) and a decline in intermediation spreads attributable to heightened competition, in part reflecting increased foreign entry.

This period also witnessed substantial measures to enhance prudential regulation and supervision, including the adoption of Basle capital adequacy standards in 1994 and a range of measures to tighten requirements on loan loss provisioning, disclosure and consolidated reporting, and loan classification, among others. Reflecting this progress, Colombia's supervisory and regulatory regime is considered one of the strongest in the region and credited with fostering more prudent risk-taking by private banks.

Notwithstanding these measures, the Colombian banking sector has also faced significant difficulties during recent years. Restrictive monetary policy in defense of the currency during late 1998, a severe recession in 1999, significant declines in the real estate market, and local governments' debt-servicing problems have all weighed on the sector's recent condition and performance.

Recent pressures were especially acute in the state-owned, savings and loans, and cooperatives sectors that together represent more than one-third of the financial system. Overall, roughly 50 institutions were intervened and a large number of these were eventually liquidated. These actions were part of an overall program to contain the crisis that involved recapitalizing the deposit insurance corporation, providing mortgage borrower relief, reforming the troubled cooperative sector, and recapitalizing the banking sector through direct grants to state-owned banks and soft-financing to private banks. The costs of the overall rescue program have been estimated at more than 8 percent of GDP, before recoveries.[14]

The generally less intense pressures on the top 25 banks in this sample (with the particularly notable exceptions of the large state-owned banks) has been attributed to their better credit risk management and high initial capital levels. Still, even these banks initially had

[14] See Swabey, Hernandez and Edkins (2000).

relatively low coverage ratios that needed to be bolstered through substantial provisions, leading in some cases to participation in the government support program.

Foreign banks have entered Colombia through a variety of routes, including reacquiring previously held majority ownership stakes (limited by joint venture requirements imposed in the 1970's and lifted in the early 1990's), de novo entry, and other acquisitions.[15] The largest transactions involved acquisition of Banco Ganadero by BBVA in 1996, and Banco Comercial Antioqueno by Banco Santander in 1997. These acquisitions coupled with organic growth by foreign banks has more than doubled the share of foreign ownership of system assets to approximately 24 percent. Roughly 60 percent of this foreign presence is attributable to Spanish banks, and one-quarter to U.S. banks.

The share of sample assets under government ownership is similar to that of foreign banks (roughly 20 percent) and the Colombian authorities have committed to privatize most institutions over the short term. In contrast to Chile and Argentina, overall concentration ratios, as measured by the share of the top 5 banks of banking system assets, remained fairly steady between 1995 and 2000 (at approximately 45 percent) although there has been notable consolidation of the nonbank financial sector over recent years.

The Sample of Colombian Banks. The larger Colombian banks that we evaluate account for 90 percent of banking system assets. The number of foreign banks is 10, or 25-28 percent of sample assets in any given year. Of these, up to 4 are excluded from the detailed analysis in any year because they are not active in the retail banking market, or are so small as to be irrelevant for a broad system discussion. These exclusions account for less than 3 percent of sample assets. Of the remaining 6 foreign banks (15 percent of sample assets), 2 are considered recent acquisitions (since 1996), and 4 have maintained local operations for an extended period of time (8 percent of sample assets).

The number of privately owned domestic banks ranges from 11 to 12, or 53-55 percent of sample assets. In any given year, only one institution accounting for less than 1 percent of sample assets is excluded due to business orientation or size. The analysis also covers several state-owned banks accounting for 18-19 percent of sample assets. In any given year, at most 2 state-owned banks are excluded, representing at most 3 percent of sample assets.

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[15] See Barajas, Steiner, and Salazar (1999) for further discussion of the history of foreign bank ownership in Colombia and an assessment of the impact of foreign banks on the overall banking sector.

Balance Sheet Structure and Liquidity. As in the case of Chile, on average foreign banks rely less on deposits for funding, hold a relatively comparable share of lower-cost demand deposits to assets, and dedicate a greater proportion of their balance sheet to lower-risk, more liquid investments than domestic private banks (See Table 7, panel A).

However, in contrast to Chile, foreign banks operating in Colombia hold relatively comparable shares of loans (at least relative to total assets). Foreign banks also appear to have overall lower balance sheet liquidity than private domestic banks, as measured by loan-to-deposit ratios (See Table 7, Panel C). Capital ratios are high at both domestic private and foreign banks, while they are significantly lower at state banks. Average loan growth was slightly higher at foreign banks than private domestic banks, while average deposit growth was comparable at both sets of institutions.

As shown in Table 7, Panels B and D, however, foreign bank trends were quite different between those banks that have entered through recent acquisitions and those with existing operations. Acquired banks demonstrate more defensive behavior, with sharply lower average loan growth, a declining share of loans in their asset mix, significant build-up in liquid assets, and improving loan-to-deposit ratios. These findings are consistent with the Chilean experience, and suggest that acquired banks during this period were more focused on consolidation than growth. Capital levels also show a larger decline at acquired banks. Foreign banks with existing operations, however, were relatively more growth-oriented, exhibiting higher average loan growth than acquired banks and domestic private banks, and a slight deterioration in liquidity ratios.

Breaking out relative loan and deposit growth across the sample period shows these divergent responses more clearly, especially in combination with the onset of difficult economic conditions. As shown in Chart 7 (Panel A), foreign banks overall show less dramatic declines in loan growth compared to domestic private banks, although, as in the case of Chile, recently acquired banks on average show steep declines (Panel B). A notable distinction across banks is seen in 2000, in which loan growth was negative at banks recently acquired, basically flat at domestic banks, and significantly positive at existing foreign banks, notwithstanding relatively stronger growth in deposits at domestic private banks.

Table 7: Summary Balance Sheet Structure of Colombian Banks
(as a percent of assets)

Panel A	Liquid Assets		Loans			
Assets	1997	2000	1997	2000		
Foreign	22	25	64	66		
Domestic Private	19	22	63	63		
Government	16	31	64	33		
	Total Deposits				Capital	
			of which: Demand			
Liabilities	1997	2000	1997	2000	1997	2000
Foreign	55	60	16	16	13	10
Domestic Private	59	70	12	17	14	12
Government	59	63	17	17	8	5

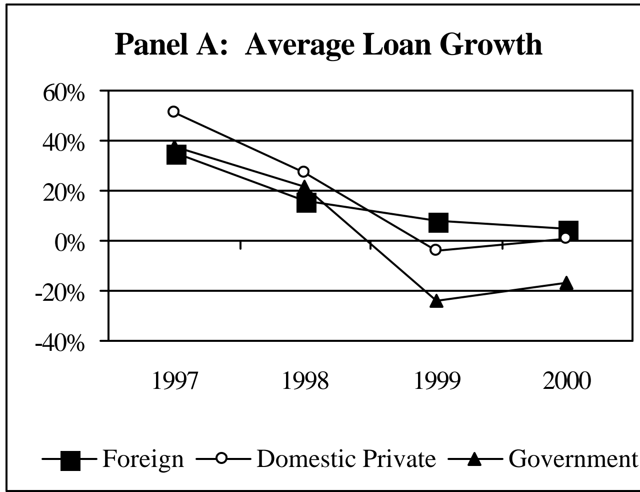
Panel B	Liquid Assets		Loans			
Assets	1997	2000	1997	2000		
Recent Foreign Acquisitions	22	37	64	53		
Existing Foreign	23	19	66	73		
Domestic Private	19	22	63	63		
	Total Deposits				Capital	
			of which: Demand			
Liabilities	1997	2000	1997	2000	1997	2000
Recent Foreign Acquisitions	56	63	18	17	16	10
Existing Foreign	57	59	15	15	13	11
Domestic Private	59	70	12	17	14	12

Loan and Deposit Trends
(1997 through 2000, in percent)

	Average Annual Loan Growth	Average Annual Deposit Growth	Loans / Deposits 1997	Loans / Deposits 2000
Panel C				
Foreign	24	28	116	108
Domestic Private	20	27	108	88
Government	-1	12	109	53
Panel D				
Recent Foreign Acquisitions	9	23	114	84
Existing Foreign	32	31	118	123
Domestic Private	20	27	108	88

Source: Authors' calculations based on data from the Superintendencia Bancaria de Colombia

Chart 7: Average Loan Growth



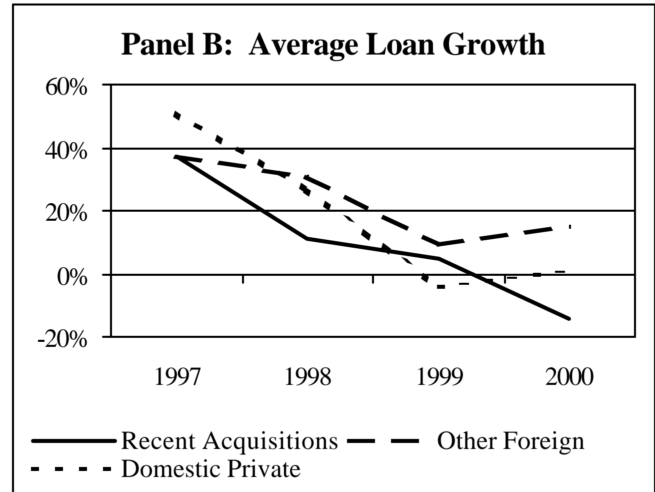
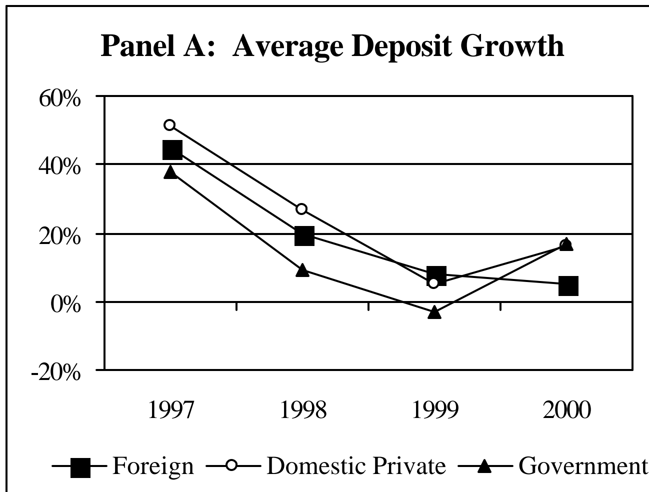
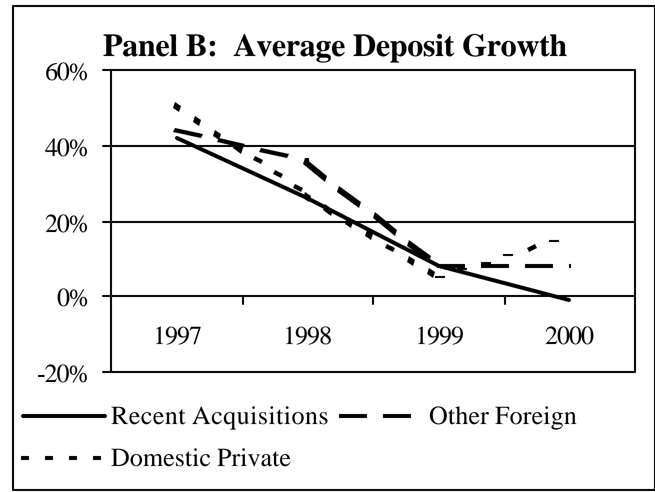


Chart 8: Average Deposit Growth





Asset Quality. As noted above, all institution types witnessed deterioration in asset quality over the period. As shown in Table 8, panel A, nonperforming loan ratios rose across all types of banks, with more notable deterioration at state banks and domestic private banks, and modest deterioration at foreign banks.[16] Both foreign and domestic private banks made aggressive provisions to address asset quality problems, and reserve coverage of NPLs improved markedly

[16] Ratios provided here for sample endpoints obscure the sharp rise in NPL ratios at state banks over the period. Average reported NPL ratios for state banks peaked at 23%, prior to recapitalization and clean-up of the sector.

over the period. Reserve coverage of NPLs at foreign banks showed the most dramatic increase, and was substantially higher than that of private banks at 138 vs. 86 percent at year-end 2000. Over the 1998-2000 period, foreign banks report higher recoveries than domestic private banks (11 percent of loans versus 7 percent, respectively), which may indicate more aggressive and effective workout skills (or simply a higher average level of charge-offs). Limited availability of charge-off data precludes a more comprehensive discussion of asset quality trends, but more aggressive provisioning and recoveries at foreign banks are suggestive of more aggressive charge-off policies.

Table 8: Selected Average Asset Quality Indicators of Colombian Banks

	% of Loans						% of NPLs	
	NPLs		Provisions		Recoveries		Loan Loss Reserves	
	1997	2000	1997	2000	1998	2000	1997	2000
Panel A								
Foreign	3.4	4.8	3.1	4.8	1.7	4.1	84	138
Domestic Private	3.8	6.6	2.9	4.5	1.6	3.3	60	86
Government	8.3	9.7	4.4	6.4	2.5	1.8	39	87
Panel B								
Recent Foreign Acquisitions	4.8	4.7	4.1	7.8	2.8	5.3	79	220
Existing Foreign	2.8	4.8	3.2	3.4	1.3	3.5	98	96
Domestic Private	3.8	6.6	2.9	4.5	1.6	3.3	60	86

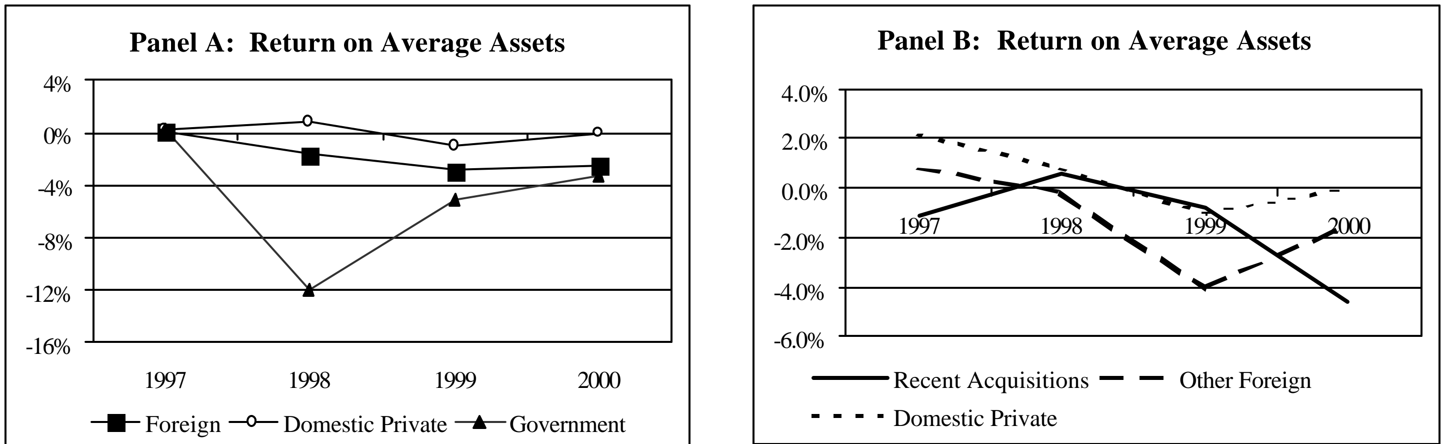
Source: Authors' calculations based on data from the Superintendencia Bancaria de Colombia.
Comparable 1997 recoveries data not available

As seen in Table 8, Panel B, acquired banks began the period with the highest average problem loan burden and made significantly higher provisions (and presumably charge-offs) to address problem loans. Although NPL ratios were basically unchanged over the period, reserve coverage improved dramatically to more than 200 percent. Existing foreign banks reported slightly higher provisions than domestic private banks over the period, achieving higher reserve coverage, and better containing increases in bad loan ratios.[17]

[17] Provisioning ratios provided here for sample endpoints do not fully represent average provision activity over the four-year period.

Earnings. On the whole, the period of economic stress is marked by a deterioration in revenue streams, increasing provisions, and high non-interest expense, contributing to declining and in some cases highly negative earnings, as shown in Chart 9. These findings are particularly true for state banks, but also for foreign banks.

Chart 9: Return on Average Assets



As shown in Table 9, Panel A, a comparison of individual income statement items across private and foreign banks suggests that foreign banks had weaker, and more negatively affected, earnings across all major categories of revenues and expenses. On average, foreign banks show weaker interest margins and non-interest income, and higher overhead and provisioning expense.

Acquired banks evidence the weakest results in terms of net interest margins, provision expense, and non-interest operating expense. Weaker interest income no doubt reflects the impact of higher relative problem loans, lower loan growth and the significant build-up in liquid assets over the period, while higher non-interest operating expenses may reflect acquisition-related restructuring costs.

Table 9: Selected Average Profitability Indicators for Colombian Banks
(as a percent of average assets)

Panel A

	Net Interest Income				Non-Interest Operating Income			
Income	1997	1998	1999	2000	1997	1998	1999	2000
Foreign	6.7	5.1	5.0	4.8	n.a.	6.0	6.6	4.6
Domestic Private	6.9	7.2	5.2	5.9	n.a.	5.8	5.3	5.5
Government	6.9	3.2	2.2	2.0	n.a.	2.7	4.7	6.5

	Provisions				Non-Interest Operating Expense			
Expense	1997	1998	1999	2000	1997	1998	1999	2000
Foreign	2.5	2.6	6.2	3.6	n.a.	9.8	9.7	9.6
Domestic Private	2.3	2.6	4.3	3.5	n.a.	9.6	8.2	9.5
Government	4.3	5.8	5.2	3.1	n.a.	12.6	7.5	8.5

Panel B

	Net Interest Income				Non-Interest Operating Income			
Income	1997	1998	1999	2000	1997	1998	1999	2000
Recent Foreign Acquisitions	7.1	7.4	4.7	4.0	n.a.	7.2	7.1	5.3
Existing Foreign	7.6	5.5	5.2	5.1	n.a.	6.3	6.3	4.3
Domestic Private	6.9	7.2	5.2	5.9	n.a.	5.8	5.3	5.5

	Provisions				Non-Interest Operating Expense			
Expense	1997	1998	1999	2000	1997	1998	1999	2000
Recent Foreign Acquisitions	3.3	3.5	5.3	5.4	n.a.	10.8	10.1	10.2
Existing Foreign	2.5	2.0	6.6	2.7	n.a.	9.4	9.5	9.3
Domestic Private	2.3	2.6	4.3	3.5	n.a.	9.6	8.2	9.5

Source: Authors' calculations based on data from the Superintendencia Bancaria de Colombia

Capital Adequacy. The very high capital levels of both domestic private and foreign banks at the beginning of the period have been important to maintaining financial institution soundness (Table 7, Panel A). State bank capital levels, which on average turned negative in 1998, benefited substantially from a large recapitalization in 1999 (although capital levels have declined further with subsequent losses). Capital injections during the period helped to maintain capital at robust levels for private and foreign banks. However, foreign bank losses were on average larger, and capital ratios declined relatively more over the period.

A review of risk-based capital ratios across the three ownership classes portrays a somewhat different story, however, as shown in Table 10. All entities show notable improvement in risk-based ratios from 1997 to 2000, with foreign bank ratios exceeding those of private domestic banks at period-end. As with Chile, this result most likely reflects lower risk levels at foreign banks, and is potentially suggestive of a more efficient use of capital by foreign banks.

Table 10: Average Capital Ratios of Colombian Banks

	Capital/Assets		Total Risk Based Capital	
	1997	2000	1997	2000
Panel A				
Foreign	13.18	10.30	11.50	12.70
Domestic Private	14.18	11.97	11.20	12.10
Government	7.88	5.28	11.50	14.30
Panel B				
Recent Foreign Acquisitions	15.60	9.92	13.30	13.90
Existing Foreign	13.20	10.50	10.60	12.10
Domestic Private	14.18	11.97	11.20	12.10

Source: Superintendencia Bancaria de Colombia

While acquired banks show the largest declines in leverage ratios, they report higher risk-based ratios than domestic private and other foreign banks, attributable to the reorientation of the balance sheet towards more liquid and lower risk investments.

Overall assessment. For the Colombian banking system as a whole, the period under review was clearly a challenging one, as banks attempted to confront a worsening operating environment and weakening asset quality by defensive measures to shore up loan loss reserves and capital, and rein in new lending. With regard to discernable differences between foreign and domestic bank performance, we observe relatively similar trends, with key differences centering primarily on foreign banks' higher average provision expense. This higher provisioning has been an important factor behind significant losses at foreign banks, but which has also led to substantially higher reserve coverage, and lower NPLs. Losses have eroded bank leverage ratios relatively more at foreign banks, but capital adequacy levels remain robust

following injections over the period, and a move towards lower-risk investments. Notwithstanding these difficulties, foreign banks on the whole have shown consistently higher average loan growth over the period.

These differences are magnified when one compares the relative condition and performance of acquired banks, existing foreign banks, and private domestic banks. Over the period, acquired banks appear mainly to concentrate on balance sheet cleansing, building liquidity, and curbing new lending. While existing foreign banks took efforts to limit asset quality deterioration and improve reserve coverage, the impact was less severe on loan growth, which was higher on average than at both acquired and domestic private banks.

The Argentine Experience. Introduction of the Convertibility Plan in 1991 marked a turning point in Argentine financial history – heralding profound monetary and fiscal reform, broad deregulation of domestic markets, privatization of government-owned entities, trade liberalization, elimination of capital controls and, more generally, a macroeconomic environment conducive to foreign investment. Pegging the Argentine peso to the dollar also succeeded in stemming hyperinflationary pressures, and restoring economic growth relatively quickly. This contributed to significant financial deepening, with bank credit to the private sector almost doubling to just under 20 percent of GDP by the mid-1990's.

Beginning in early 1995, contagion from Mexico's Tequila Crisis severely tested the Argentine financial sector – sparking an outflow of almost 20% of system deposits. It was in the wake of the Tequila Crisis that the transformation of the Argentine financial sector accelerated. Efforts undertaken to re-establish confidence in the banking sector included the introduction of deposit insurance, a renewed commitment to privatizing inefficient public sector banks, the liquidation and/or consolidation of nonviable entities, and the dedication of substantial resources to strengthening supervisory oversight and the regulatory framework. Within this context, foreign banks were permitted to play an important role in recapitalizing the Argentine banking system.

Prior to the 1990's, very few foreign banks were present in Argentina, with the U.S. institutions among the more active. Following the removal of restrictions on foreign direct investment and capital repatriation, the number of foreign banks operating in Argentina increased, but remained under 20 percent of system assets through 1995. Subsequent entry

occurred mainly via the acquisition of existing operations, with foreign shareholders acquiring stakes in private institutions with a national or regional franchise – generally in better condition and with stronger distribution networks than privatized provincial and municipal banks. By 1999, roughly half of banking sector assets were under foreign control (with foreign shareholders holding significant minority stakes in a number of other financial institutions). Roughly one-third of this foreign presence is currently controlled by U.S. and Canadian banks, and two-thirds by European entities – half of which by Spanish banks.

Strong economic recovery in 1996 and 1997 was accompanied by a resurgence of deposit growth (averaging in excess of 20 percent per year), and a further deepening of bank credit to the private sector – reaching 24 percent of GDP by 1998. This period also witnessed the broad-scale adoption of direct deposit salary payments, which further assisted bank penetration. However, in the wake of the Asian, Russian and Brazilian financial crises, a tighter financing environment, volatile interest rates and deteriorating terms of trade – combined with domestic electoral uncertainties – adversely affected growth prospects. In 1999, Argentina's economy contracted 3.4 percent and has yet to evidence a recovery.

Although the Argentine financial sector generally weathered this recent period of financial stress relatively well, deposit growth markedly slowed, credit to the private sector stagnated, and the quality of bank assets deteriorated. The following analysis evaluates the relative performance and condition of domestic and foreign banks from 1997 to 2000.[18]

The Sample of Argentine Banks. The Argentine banks that we evaluate account for 80 – 85 percent of system assets over the sample period. The number of foreign-controlled entities ranges from 15 to 18, representing 50 to 61 percent of sample assets in any given year. Of these, several have been excluded from detailed analysis because they are not active in the retail banking market, or are so small as to be irrelevant for a broad system discussion and their inclusion would inappropriately affect unweighted averages. In any given year, up to seven foreign-controlled banks, or 8 percent of system assets, have been excluded under these criteria. Of the remaining foreign banks, seven are considered to be recent acquisitions (since 1995), equivalent to roughly 35% of sample assets, and five have longer-standing local operations (approximately 25% of sample assets).

[18] The statistics discussed in this section are compiled using a variety of sources, including the Argentine central bank and Moody's.

Among domestic banks, the number privately owned ranges from 1 to 3, or 11 to 14 percent of sample assets. All are considered to be retail oriented, and of adequate size for inclusion in this analysis. Only one, roughly 10% of sample assets, remains under private domestic ownership throughout the entire period. Despite significant privatization in the wake of the Tequila Crisis, government-controlled banks maintain a significant presence in Argentina. Up to six of these banks are included in our sample in any given year, representing 29 to 36 percent of sample assets. For purposes of this analysis, we have excluded from consideration two banks (roughly 4 percent of system assets) due to size and business orientation.[19]

Balance Sheet Structure and Liquidity. Consistent with the prior cases, foreign banks in Argentina, on average, dedicate a relatively larger proportion of their balance sheets to liquid assets than do domestic private banks (Table 10, Panel A). However, in contrast to Chile and Colombia, foreign banks in Argentina exhibit broadly comparable reliance on deposit-based financing as private domestic peers. They also hold a similar proportion of assets in loans, and even started the sample period with, on average, a higher loan-to-asset ratio (this point is consistent with the Colombian case). This may reflect the relatively earlier timing of most major foreign acquisitions in Argentina and Colombia than in Chile. In Argentina's case, this may also reflect entry coincident with a strong economic recovery (and strong average deposit and loan growth), a higher volume of acquisitions and, a broader acquisition focus beyond just top tier institutions. However, unlike the Colombia experience, as the macro environment deteriorated, foreign banks exhibited a sharper reduction in loans as a proportion of assets, and a much faster buildup of less risky, liquid investments (primarily government securities) – contributing to lower loan-to-deposit ratios and enhanced liquidity. Although, as in all cases, foreign banks' average loan growth over the sample period exceeded that of domestic private and public banks (Table 11, Panel C).

[19] In particular, the national mortgage bank was excluded from consideration due to its unique financing profile and credit orientation.

Table 11: Summary Balance Sheet Structure of Argentine Banks

(as a percent of assets)

Panel A	Liquid Assets		Loans			
Assets	1997	2000	1997	2000		
Foreign	32	47	61	52		
Domestic Private	36	39	59	55		
Government	35	47	55	51		
	Total Deposits				Capital	
			of which: Demand			
Liabilities	1997	2000	1997	2000	1997	2000
Foreign	56	54	6	4	9	8
Domestic Private	57	57	6	4	9	9
Government	68	76	5	4	8	6

Panel B	Liquid Assets		Loans			
Assets	1997	2000	1997	2000		
Recent Foreign Acquisitions	34	47	60	51		
Existing Foreign	29	46	63	53		
Domestic Private	38	39	57	55		
	Total Deposits				Capital	
			of which: Demand			
Liabilities	1997	2000	1997	2000	1997	2000
Recent Foreign Acquisitions	55	55	6	4	9	9
Existing Foreign	60	53	6	5	8	8
Domestic Private	50	57	6	4	10	9

Loan and Deposit Trends

(1997 through 2000, in percent)

	Average Annual Loan Growth	Average Annual Deposit Growth	Loans / Deposits 1997	Loans / Deposits 2000
Panel C				
Foreign	22	2	113	96
Domestic Private	15	22	107	97
Government	4	17	81	69
Panel D				
Recent Foreign Acquisitions	12	16	113	93
Existing Foreign	36	26	108	102
Domestic Private	15	22	115	97

Source: Authors' calculations based on data from the Banco Central de la Republica Argentina

Perhaps reflecting earlier large-scale entry, banks acquired since 1995, and other foreign banks present at least since the early 1990's, exhibit more similar balance sheet structures and trends than in the other two case studies (Table 11, Panel B). However, recently acquired banks do maintain significantly lower average loan and deposit growth rates over the sample period (Table 11, Panel D), and curtail new lending (in particular) and deposit taking more quickly and sharply than their other private sector counterparts (Charts 10 and 11, Panels B). Growth trends also appear slower to recover at these banks – consistent with our findings in Chile and Colombia. In contrast, and also consistent with the other case studies, existing foreign banks reduce loan and deposit volumes more slowly than domestic counterparts as operating conditions deteriorate, and appear to reactivate new lending more quickly as the credit environment improves.

Chart 10: Average Loan Growth

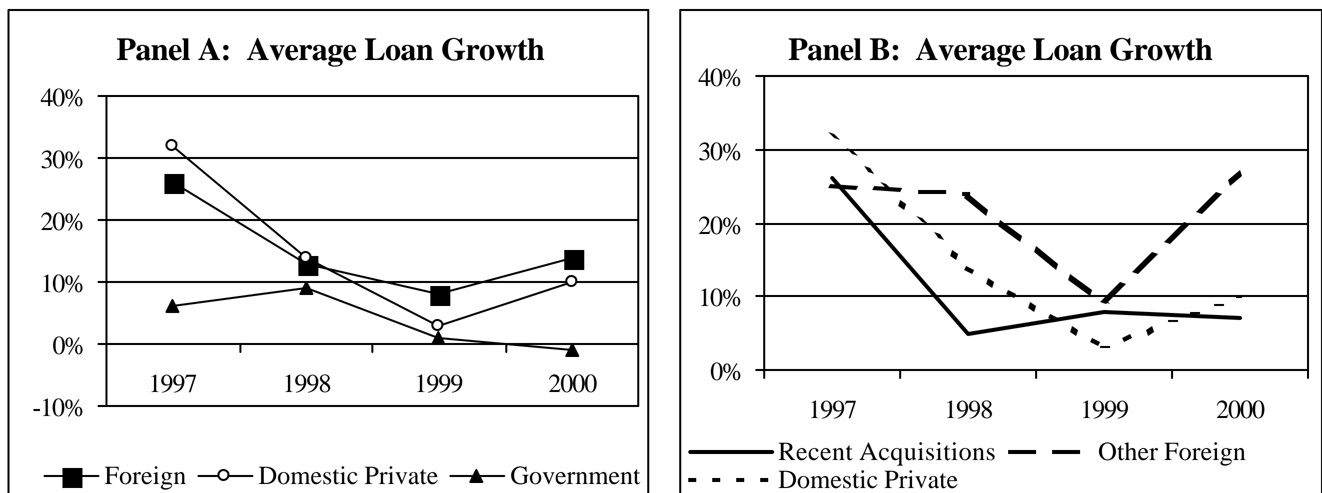
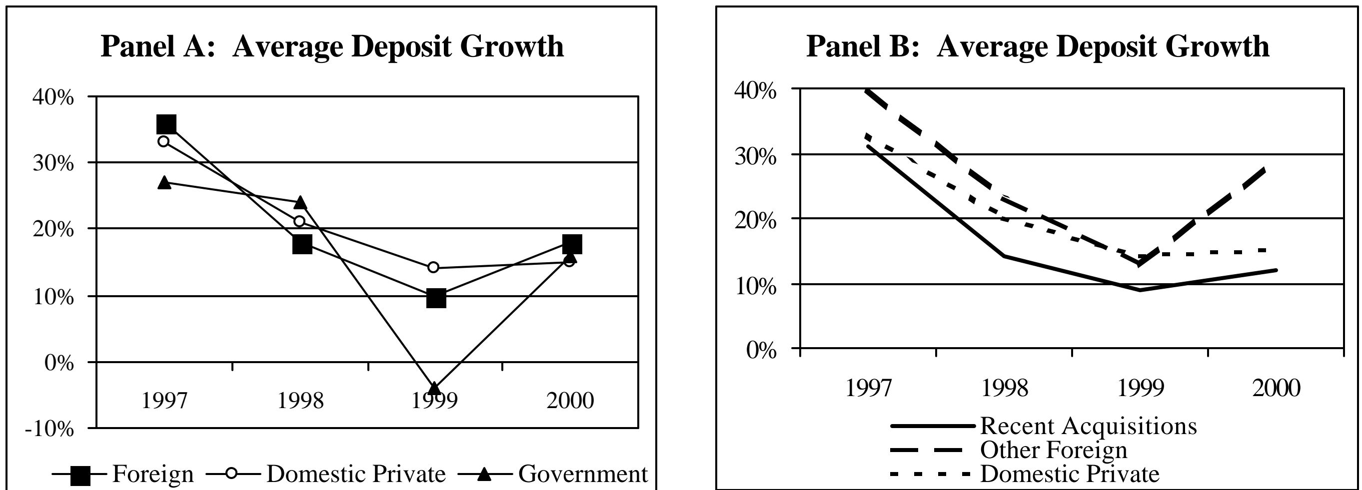


Chart 11: Average Deposit Growth



Asset Quality. From 1997 to 2000, sample banks experienced a notable deterioration in asset quality, with the average stock of non-performing loans (NPLs) rising to over 10 percent of gross loans. While Argentina's large public sector banks exhibit particularly weak asset quality indicators, private sector banks also report a significant deterioration in credit quality over this time period (Table 12, Panel A). However, in contrast to both Chile and Colombia, asset quality deterioration is concentrated in foreign banks, with their private domestic peers reporting better NPL ratios by 2000. Foreign banks appear to have experienced either a more severe deterioration in credit quality, or responded more quickly and aggressively in acknowledging potential losses. However, the deteriorating trend in foreign-bank asset quality ratios, and the improving outlook for domestic private banks – along with their shrinking number – suggests relative credit quality trends are being driven to some extent by on-going foreign acquisition of lesser-quality domestic banks.

Table 12: Selected Asset Quality Indicators of Argentine Banks								
	% of Loans						% of NPLs	
	NPLs		Provisions		Recoveries		Loan Loss Reserves	
	1997	2000	1997	2000	1997	2000	1997	2000
Panel A								
Foreign	6.5	8.7	2.5	3.8	0.2	0.3	83	78
Domestic Private	5.3	3.5	2.8	2.6	0.2	0.3	76	77
Government	17.8	18.5	2.1	2.2	0.2	0.2	60	57
Panel B								
Recent Foreign Acquisitions	7.0	8.7	3.0	3.8	0.3	0.4	81	84
Existing Foreign	5.4	8.7	2.1	3.8	0.1	0.1	84	69
Domestic Private	4.7	3.5	2.2	2.6	n.a.	0.3	71	77

Source: Authors' calculations based on data from the Banco Central de la Republica Argentina

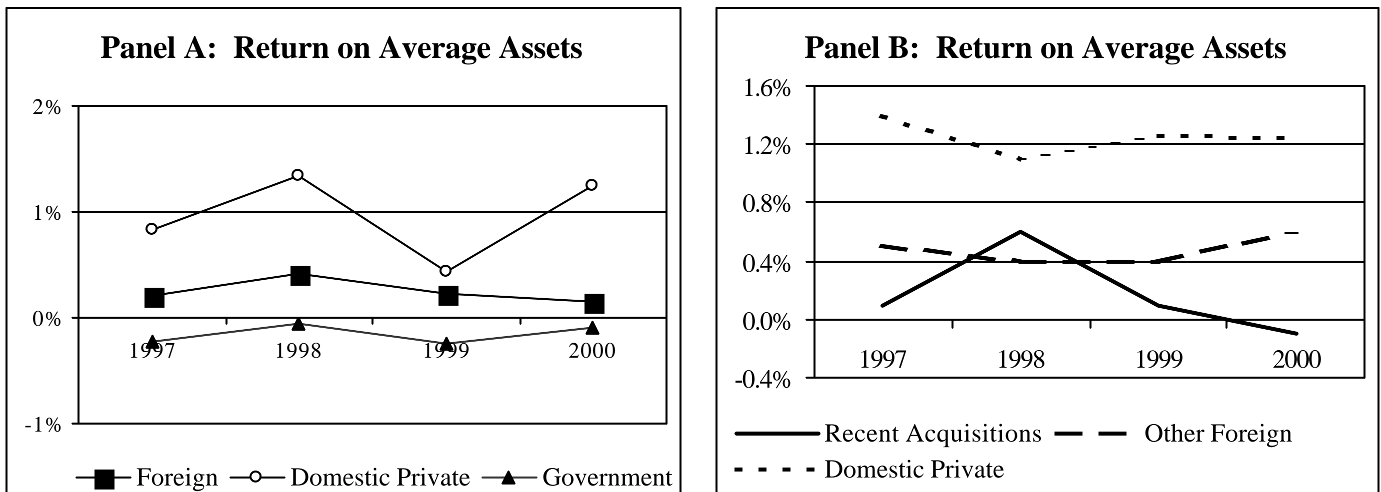
As in both prior case studies, recently acquired foreign banks entered the sample period with higher NPL ratios than foreign banks with a longer-standing presence in the local market – possibly reflecting the absorption of entities with less sound credit risk management practices (Table 12, Panel B). And as in Chile, but not Colombia, asset quality indicators at these banks continued to deteriorate throughout the sample period, perhaps the result of on-going acquisitions (which were absent in Colombia). Longer-established foreign banks also experienced a notable deterioration in asset quality as the macro environment deteriorated – and more marked given their relatively stronger asset quality ratios at the onset of the sample period. This was also evident in Colombia, where longer-established foreign banks similarly concluded the sample period with comparable NPL ratios to acquisition banks.

Similar trends are evident in provisioning activity – with foreign acquired banks entering the mid- to late- 1990s with higher provision expenses relative to average loans than peers, and maintaining higher loan loss provisions than domestic banks throughout the sample period, but ultimately matched by existing foreign banks at the end of the period. Despite this accelerated provisioning activity, flat to declining loan loss reserves at foreign banks suggest that the recognition of credit losses outpaced reserve buildup, perhaps indicative of relatively more aggressive charge-off practices. As in the other case studies, acquired foreign banks also enter the sample period with significantly higher recovery ratios, and maintain or grow these

throughout the sample period. Across all four years, these banks recover 1.1 percent of average loans, as compared to 0.2 percent by existing foreign banks and 0.5 percent by domestic private banks.

Earnings. Foreign-controlled banks have consistently generated weak returns over the sample period, and significantly under-performed private domestic banks, although not state banks (Chart 12, Panel A). In general, this reflects somewhat weaker net interest revenues, and higher provision and operating expenses (Table 13, Panel A).

Chart 12: Return on Average Assets



As is evident in Chart 12, Panel B, on average all foreign banks – whether long present in the local market or recent acquirers – have performed poorly relative to the remaining large private bank under domestic control. As in Chile, recent acquisitions have exhibited particularly weak performance – reflecting declining net interest margins (consistent with a more pronounced and marked retrenchment from credit activities), and heavy provision expenses. Of note, though, these banks also appear to be relatively more successful than their longer-established peers in reducing operating expenses over the sample period (Table 13, Panel B) – perhaps pointing to enhanced returns in the future. Consistent with credit and deposit growth patterns, longer-established foreign banks have benefited from rising net interest flows, and have generated relatively strong operating revenues as well – perhaps reflecting the absence of distracting merger issues. However, they also maintain relatively expensive cost structures.

Table 13: Selected Profitability Indicators for Argentine Banks
(as a percent of average assets)

Panel A

Income	Net Interest Income				Non-Interest Operating Income			
	1997	1998	1999	2000	1997	1998	1999	2000
Foreign	4.6	4.8	4.6	4.7	2.5	3.0	2.7	2.6
Domestic Private	5.2	4.9	4.7	4.9	2.5	3.3	3.4	2.5
Government	3.6	4.7	2.6	3.3	2.6	2.8	2.3	2.4

Expense	Provisions				Non-Interest Operating Expense			
	1997	1998	1999	2000	1997	1998	1999	2000
Foreign	1.6	1.6	1.8	2.0	5.5	6.0	5.5	5.2
Domestic Private	1.7	1.2	2.0	1.5	5.2	5.8	5.7	4.5
Government	1.2	1.5	0.8	1.0	6.0	7.1	4.6	5.0

Panel B

Income	Net Interest Income				Non-Interest Operating Income			
	1997	1998	1999	2000	1997	1998	1999	2000
Recent Foreign Acquisitions	4.8	4.7	4.1	4.2	2.5	2.9	2.4	2.4
Existing Foreign	4.6	5.0	5.8	5.6	2.7	3.4	3.7	2.9
Domestic Private	4.7	3.9	4.1	4.9	2.1	1.9	2.5	2.5

Expense	Provisions				Non-Interest Operating Expense			
	1997	1998	1999	2000	1997	1998	1999	2000
Recent Foreign Acquisitions	1.9	1.6	1.7	2.0	5.4	5.8	5.0	5.1
Existing Foreign	1.4	1.6	2.3	2.1	5.7	6.5	6.6	5.6
Domestic Private	1.3	0.7	1.5	1.5	4.3	4.0	4.6	4.5

Source: Authors' calculations based on data from the Banco Central de la Republica Argentina

Capital Adequacy. Broadly speaking, foreign banks in Argentina (as in Colombia) appear to have maintained comparable, if slightly lower, capital-to-asset ratios than their privately held domestic counterparts (Table 14, Panel A). Again, state banks notably under-perform in this regard. As in the other countries, foreign banks witnessed a moderate deterioration in total capital levels relative to the asset base over the sample period, likely reflecting heavier provision expenses, merger integration costs and, perhaps, a different calculus in the efficient allocation of capital.

Table 14: Average Capital Ratios of Argentine Banks (percent of assets and risk-weighted assets, respectively)				
	Capital / Assets		Total Risk-Based Capital	
	1998	2000	1998	2000
Panel A				
Foreign	8.90	8.31	17.12	17.56
Private Domestic	8.89	9.00	17.75	16.71
Government	8.18	6.04	n.a.	n.a.
Panel B				
Recent Foreign Acquisitions	9.21	8.54	17.99	18.17
Existing Foreign	8.31	7.91	15.90	16.50
Domestic Private	9.64	9.01	17.19	16.71
Source: Banco Central de la Republica Argentina				

As in Colombia, but not Chile, foreign acquired banks entered the period with higher capital ratios than longer-standing foreign banks – perhaps reflecting higher recapitalization needs to effect balance sheet cleansing (Table 14, Panel B). These banks also witnessed a sharper deterioration in capital levels as a proportion of assets throughout the sample period – consistent with dampened earnings as a result of on-going high provision and merger integration expenses – although they remain above their foreign counterparts.

However, as in the other two countries, foreign bank risk-based capital ratios improved over the sample period, exceeding levels maintained by domestic banks. This is consistent with the trend toward lower-risk asset holdings at these banks, and also suggests foreign and domestic banks may differ in their ability to efficiently allocate capital.

Overall Assessment. As in Chile, the Argentine financial sector as a whole weathered this economic downturn relatively well. An important distinction between Argentina and the other case studies, however, is the broader penetration of foreign banks, the winnowing presence of large domestically owned banks, and the still significant state bank presence. As a result, more meaningful results derive from the evaluation of recent foreign entrants, as compared to longer-established foreign players.

Overall, these banks exhibit broadly similar trends. However, as in Chile and Colombia, acquired banks retrench from deposit and loan markets more quickly and more markedly than other local foreign players, and appear to re-engage more slowly. This may be due to the costs and energies associated with merger integration, and may be a temporary short-run phenomenon as management engages in balance sheet cleansing and a reconciliation of risk management and operational practices. This would be consistent with the higher NPL ratios reported by these banks, and heavier provisioning expenses – all of which have weighed on performance. However, healthier balance sheets and enhanced cost management may point to stronger, and more sustainable returns in the longer term.

IV. Conclusions

Our analysis shows that foreign and domestic private banks do not exhibit strong systematic differences in condition and performance over the sample period, although the broader BFSR analysis indicates some marginal relative improvement of the ratings of foreign acquired banks compared to domestic banks over time. Across all measures, private banks, both foreign and domestic, exhibit clearly superior health relative to state banks. The case studies, however, indicate some noteworthy distinctions between foreign and domestic private banks in balance sheet structure, loan growth, measures to address asset quality deterioration, and loss-absorption capacity.

In terms of balance sheet structure, foreign banks rely to a lesser extent on deposit-based funding, potentially reflecting access to alternative funding sources and/or difficulty in attracting deposits from entrenched local competitors. Foreign banks do, however, have comparable shares of lower-cost demand deposits. Foreign banks also maintain higher shares of liquid assets, perhaps paralleling a greater reliance on potentially more volatile non-deposit borrowings. Foreign banks tend to maintain similar or lower loan shares, and similar or weaker overall liquidity as measured by loan-to-deposit ratios.

Across all three countries, foreign banks manifest consistently stronger average loan growth than domestic private banks. This is particularly true for existing foreign banks, which over the sample period on average show less reduction in credit growth with the onset of weakening economic conditions than domestic private banks, and stronger growth with macroeconomic improvement. The higher relative share of liquid assets maintained by foreign banks may support such a redeployment of assets. Recently acquired foreign banks show more

defensive behavior, with loan growth consistently ranking below that of established foreign banks and domestic private banks, and a more rapid build-up in liquid assets. Acquired banks' behavior is consistent with a greater initial focus on operational restructuring, balance sheet cleansing, and integration of local operations with the parent bank, rather than on market share expansion and growth.

With respect to asset quality trends, our results are mixed in terms of differences in current levels and trends in non-performing loan ratios across foreign and domestic banks. Ambiguous results may not be altogether surprising, however, given traditional difficulties in evaluating bank asset quality by outside analysts, particularly in an emerging markets context: definitions of problem loans across countries often vary, and individual banks within a country may apply the same standard differently. Gaining a better understanding of differences in asset quality across ownership types would require much more detailed data, beyond the scope of this review.

More concrete findings concern provisioning for bad loans. Foreign banks have higher loan provisioning expenses and comparable or higher reserve coverage of non-performing loans, potentially suggesting tighter credit review standards. Foreign banks also report higher average recoveries than private domestic banks, reflecting higher provisions (and presumably charge-offs) which may be attributable to more aggressive and/or effective workout procedures (or simply higher average charge-offs). These observations especially characterize recently acquired banks, which also have higher initial problem loan levels and correspondingly generally higher provisioning and recoveries over the period. Overall, we conclude that foreign banks appear to take more aggressive actions in addressing asset quality deterioration.

In terms of earnings, over the sample period foreign banks had similar or weaker overall profitability than domestic banks. Foreign banks tend to have similar or weaker net interest margins, while non-interest income levels (as a percent of total assets) vary 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).[20] Foreign banks also report comparable or higher non-interest expense.

[20] 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.

Lastly, with respect to loss-absorption capacity, notwithstanding similar or weaker profitability levels, foreign banks maintain higher risk-based capital ratios than domestic private banks across all three countries. This is particularly notable in cases where foreign banks have suffered large losses, such as Colombia. Higher risk-based ratios reflect foreign banks' relatively greater investment in liquid and lower-risk assets. Moreover, foreign banks' higher risk-based capital ratios – but generally lower capital-to-assets ratios (Argentina and Colombia) – may point to potential differences between foreign and domestic banks in the efficient allocation of bank capital.

Given the wide range of relevant institutional and structural variables, the relatively short gestation period of significant foreign ownership, and the difficult macroeconomic conditions existent over the sample period, caution is warranted in generalizing our findings from the recent Latin American experience to the broader implications of foreign ownership for domestic financial stability. That said, some preliminary observations can be made.

First, the lack of strong differences in condition and performance between foreign and domestic private banks may suggest that there is space for strong domestic and foreign institutions to compete effectively in local banking markets.

Second, consistently stronger average loan growth by foreign banks is supportive of similar recent findings that foreign banks do not necessarily "cut and run" during periods of economic difficulty in emerging markets. While recently acquired banks had lower loan growth, their focus on balance-sheet repair could potentially provide the foundation for future credit growth, more similar to that of longer-standing foreign banks.

Third, the "cherry-picking" critique often aimed at foreign banks is challenged by some of our case study findings. While existing foreign banks began the period with similar or lower average NPL ratios, suggestive of the "cherry-picking" critique, these banks had relatively higher provisioning levels compared to domestic private banks during the period. If relative provisioning reflects relative deterioration, it is hard to conclude that the portfolios of foreign banks consist of significantly more creditworthy borrowers than those of domestic private banks. Alternatively, if foreign banks do target low-risk clients, higher provisioning at foreign banks suggest that domestic private banks may be under-provided against potential loan losses.

Generally higher provisioning at foreign banks, particularly in the immediate aftermath of acquisitions, coupled with comparable or higher reserve coverage of bad loans, may suggest

that foreign banks apply tighter credit review standards to their portfolios. If this is the case (which would require a more qualitative review of differences in bank credit review standards to more fully support), foreign bank participation may have broader positive efficiency implications, if weaker credits are identified earlier, and banks more quickly reallocate resources from weaker to stronger credits.

Lastly, the comparable or weaker earnings performance by foreign banks over this period, while maintaining higher risk-based capital ratios than their domestic counterparts, is suggestive of a strong commitment to the local presence by head office, and further argues against the "cut and run" critique.

Taken together, our findings that foreign banks have consistently stronger average credit growth, take more aggressive action to deal with asset quality deterioration, and possess the capacity and willingness to sacrifice short-term profitability for longer-term soundness, suggest that foreign ownership may have quite positive implications for financial sector stability, development, and efficiency. Before extending these conclusions too far, however, more extensive analysis of these issues is clearly warranted. These ownership changes in Latin America remain relatively recent. Moreover, they have taken place during a rather inhospitable macroeconomic environment. The longer-term competitive dynamics of substantially increased foreign ownership may only be more fully evident over time. Second, a fuller treatment of the structural and institutional differences across countries should inform this debate considerably. Third, our analysis has been based on the "average" bank experience, and more explicit segregation of institutions by such variables as size, customer base, national or regional scale, etc. would shed greater light on observed institutional differences. Fourth, this analysis is largely centered on quantitative rather than qualitative indicators of bank condition: a better understanding of qualitative differences in risk management and internal controls, particularly in the area of credit risk management, would also be informative. Lastly, a more in-depth analysis of loan portfolio composition and asset quality trends would be useful to better gauge the issue of whether foreign and domestic banks systematically differ in their lending strategies and customer orientation.

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