International Operations of Canadian Banks and Exposure to the Financial Crisis

Presentation prepared for the International Roundtable on Reducing Vulnerability to Financial Meltdown: Assessing Alternatives

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Hugues Létourneau and Pablo Heidrich
The North South Institute
Why internationalization matters?

Banking is one of the largest industries in Canada, and one of the most internationalized. It provides key domestic roles, as well as international ones for domestic clients:

- Central role providing credit for production and trade
- Underwriter for new stock issuing and bonds

Canadian banking is heavily internationalized, with over a third of its operations done abroad, and accounting for close to 50% of its profits (average 2007-2009).

Banking as an industry generates unique challenges to governments. Its internationalization is often a blind spot.

- Regulators suffer serious informational disadvantages
- Business complexity can pervert regulatory intentions
- Social costs of firm level mistakes abroad might be enormous, with domestic consequences.
Structure of the study

Two parts, answering:

- Where are Canadian banks present abroad and why are they there?
- Why have they suffered so little given their large international expansion?

Method: exploratory, qualitative analysis grounded on existing theoretical literature. Can be expanded into detailed case studies, or with econometric techniques.

Each section has two steps:

- Survey of literature on determinants of financial foreign direct investment
  - Plus evaluation of empirical evidence from Canadian banks
- Survey of the lit on determinants of crisis contagion via banking internationalization
  - Plus evaluation of losses of Canadian banks where they operate
Historical account of Canadian banks’ expansion

**First wave**: accompanying Canadian growth in late XIX and early XX Century, using colonial connections to expand in the Caribbean via trade financing and wealth management. Retreated with Great Depression.

**Second wave**: started in 1960s, peaked in the 1980s, relatively concentrated in developed countries and a large expansion of bank loans to emerging countries. Large losses from the 1982 Latin American debt crisis and new retreat.

**Third wave**: started during the second half of the 1990s, with purchases of US, Caribbean and Latin American banks, moderate expansion of cross-border loans.

**Currently**, Canadian banks are expanding into East Asia, BRICS and remained interested in opportunistic purchases of troubled US banks.
Where do Canadian banks operate?

Legend:
- **Scotia:** Significant retail and commercial activities
- **Scotia:** 5 or less branches and/or minority ownership (RBC in blue)
- Significant retail and commercial activities by two or more banks
- Limited retail and commercial activities and/or minority ownership by two or more banks

**Central and South America:**
- Belize
- Chile
- Costa Rica
- El Salvador
- Panama
- Peru
- Guyana
- Suriname

**North America:**
- United States
- Mexico

**Asia:**
- China
- India
- Malaysia
- Thailand

The map shows the regions where Canadian banks operate, with different shades indicating the level of activity.
Main explanatory factors

Push factors:

- Oligopolic position in domestic market (internationally higher than average rate of profits)
- Limits to domestic growth
  - Regulatory limits to mergers
  - Low population or economic growth
- Changing needs to domestic clients
  - Internationalization or regional integration
Main observed determining factors

Å Trade and other integration drivers:
   - Penetration seems to have followed trade integration in NAFTA, but been preceded by trade increase in Peru. Increase in trade (goods and services) seems to incline banks to consolidate presence in given countries. Immigration could be relevant, too.

Å Profit opportunities abroad:
   - Demographic potential: low average ages, higher literacy rates

Å Cultural similarity:
   - Preference for US and Caribbean, similar languages, culture, and political/legal systems.
   - Scotiabank is a case of learned acculturation in Latin America now and perhaps, East Asia in the future.
Financial Crisis and Foreign Operations

- Used BIS Consolidated banking stats data (quarterly) and Bank of Canada Banking and Financial Statistics: data allowed to look at the evolution of foreign claims of home country national institutions (dominated by Big 5)
- Included in foreign claims: assets (credit, mortgages on balance sheet foreign exposure)

Where are Canadian foreign claims located?

Geographical division of Canadian bank foreign claims in Q1-2008

- US, 55.86%
- UK, 14.01%
- Rest of Western Europe, 10.79%
- Offshore banking centre, 5.51%
- Latin America and Caribbean, 7.52%
- Other, 6.31%

Source: BIS Consolidated Statistics
Writedowns and Credit losses between Q3-2007 and April 2009 in USD billions
Banks' cases of crisis exposure demonstrate that local currency positions are more stable during the crisis than cross-border lending. By extension, countries where banking systems hold a larger part of their foreign claims as local claims in local currency have been less vulnerable to global funding disruptions up to the end of 2009.

<table>
<thead>
<tr>
<th>Country</th>
<th>Local currency claims as a percent of total foreign claims in Q4-2009</th>
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<tbody>
<tr>
<td>Japan</td>
<td>15.82%</td>
</tr>
<tr>
<td>Germany</td>
<td>17.34%</td>
</tr>
<tr>
<td>Belgium</td>
<td>30.52%</td>
</tr>
<tr>
<td>United States</td>
<td>32.66%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>42.88%</td>
</tr>
<tr>
<td>France</td>
<td>48.37%</td>
</tr>
<tr>
<td>Italy</td>
<td>49.71%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>53.19%</td>
</tr>
<tr>
<td><strong>Canada</strong></td>
<td><strong>59.90%</strong></td>
</tr>
<tr>
<td>Australia</td>
<td>71.83%</td>
</tr>
<tr>
<td><strong>All countries</strong></td>
<td><strong>34.57%</strong></td>
</tr>
</tbody>
</table>

Source: BIS Consolidated Statistics
Conclusions

• Canadian banks have shown greater resilience than average of OECD countries in their positions abroad during this crisis.

• The reasons for the low exposure is to have conservative behaviours in very risky markets, such as the US, or a relative balanced portfolio of investment among countries.

• Combination of following the client strategies, concentration in retail services for local populations, and avoidance of complex financial engineering provide a rather dull but effective method of expansion abroad.

• Ultimately, expansion abroad is functional and complementary to their oligopolic and dominant position at home.