OTC Derivatives Reform

Unintended Regulatory Consequences? The Emerging Market Opportunity

Mayra Rodriguez Valladares, MRV Associates
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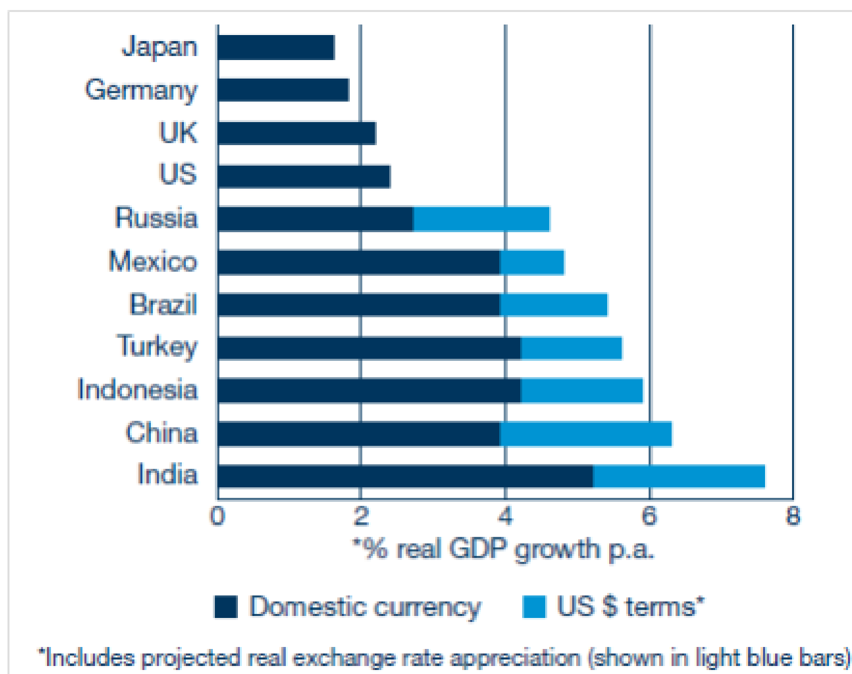
Regulatory pressure on US and European banks from Basel III and Dodd-Frank is likely to create an opportunity for emerging market banks.

There is renewed interest in emerging markets -- primarily due to the fact that the top emerging markets are growing while growth in the so-called developed countries has been anemic and, in some European countries, declining. Yet financial regulatory developments should also generate investor interest in emerging markets, since banks in developed markets may have a hard time expanding or even sustaining their forays in emerging markets as they try to comply with Dodd-Frank, Basel III and European regulations. Meanwhile, domestic economic data and foreign banks' financial and regulatory woes point to very good growth opportunities for emerging market banks (*see chart, below*).

Exhibit 1: Projected Average Real GDP Growth, 2005-2050



Source: PricewaterhouseCoopers.com

State of Financial Regulations

Even though many of Basel III's components have been watered down or delayed, the EU and US have reiterated that they are committed to implementing the regulation. Banks have been deleveraging for the past three years in order to be able to comply with stricter capital requirements and with Dodd-Frank's Volcker Rule; even though the Volcker Rule has not been finalized to date, banks including Goldman Sachs and Morgan Stanley have divested from some US assets, such as hedge funds and commodity units. More recently, both Citibank and HSBC have been closing down some offices in emerging markets and are still looking to sell some assets in those markets.

Foreign banks -- especially European institutions -- have argued that financial regulations will make it difficult for them to lend to emerging markets. If banks from developed markets do curtail trade and project finance deals in emerging markets, foreign shadow financial

institutions might step in; but emerging market banks are well poised to step in to pick up some of the transactions typically dominated by the large foreign banks.

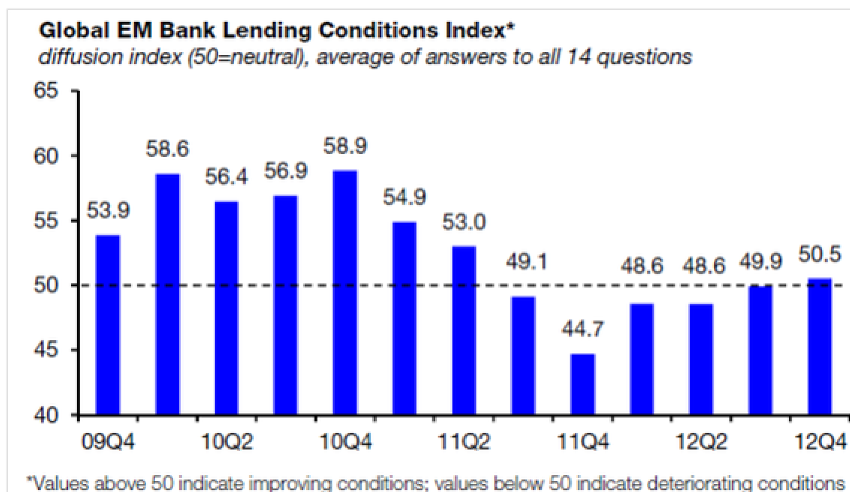
Exhibit 2: Highlights of Current Size of Banking Sector

Source: PricewaterhouseCoopers

In the UK and US, there has been renewed talk of breaking up the Too-Big-to-Fail Banks. But it is difficult to tell whether, in the current US political environment, this talk would really turn into action. Nonetheless, US banks are likely to focus their efforts on domestic issues rather than increasing activities in emerging markets further.

Emerging Market Credit Markets

Meanwhile, lending conditions in emerging markets improved through 2012 (*see chart, next page*). Monetary policies in emerging markets, influenced by those in developed markets, have been very accommodative, especially in Latin America and Emerging Europe.



Source: Institute of International Finance, 30 January 2013

In years to come, it will probably be retail banking that will grow the most in emerging markets, given how underdeveloped consumer and mortgage lending have been in those markets. Until recently, emerging market corporations have been much more reliant on loans and traditional forms of financing. Yet there are signs of increasing bond and stock issuance in some key emerging market countries.

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As of 2012, emerging market bond issues account for almost a third of all global bond issuances; this is a significant jump from a decade ago. Moreover, while the majority of issues are concentrated in banks, increasingly there are issuers from other sectors. All of these corporations are prime targets for emerging market bank services.

While presently foreign banks dominate about 50% of equity offerings and 45% of bond offerings, domestic banks also want to compete against foreign financial institutions to underwrite these transactions. As foreign banks are under more and more pressure to improve their risk management and capital ratios, it would not be surprising if they focus more domestically than in emerging markets. Given the lingering effects of the 2008 financial crisis, bank supervisors in emerging markets are watching very carefully how securities and derivatives transactions expand in their markets.

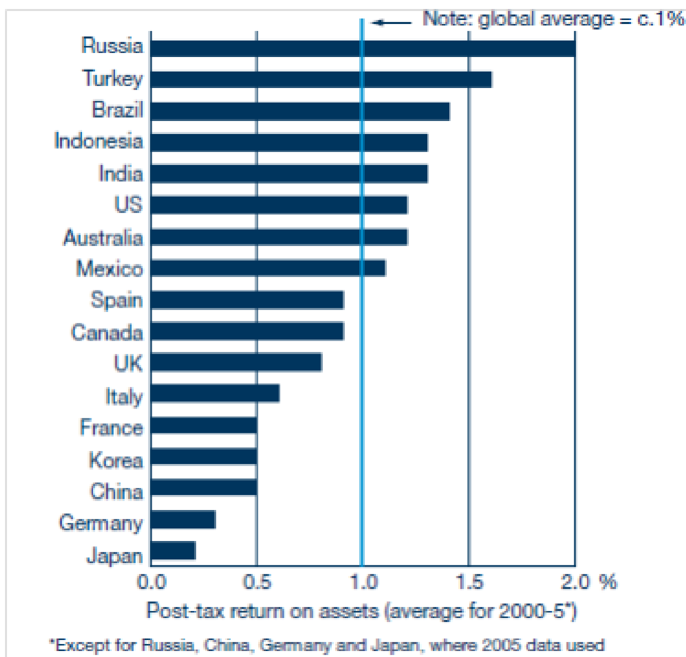
Emerging Market Bank Risks: What to Watch For

Like investors in any other bank, investors in and counterparties to emerging market banks should analyze very carefully the country and economic risks in the home country of the emerging market bank. Also, analyzing emerging market banks' credit risk is extremely important since credit risk is often not well identified, measured, controlled or monitored at many developed market banks, not to mention emerging market institutions. Operational risk management at emerging market banks tends to be a very weak area since even understanding operational risk is a pretty new concept in these countries.

[*Related:* "Brazil Sparkles, Offers a Model for US Markets"]

If emerging market banks start to grow, that will pose challenges to bank supervisors in emerging markets; bank supervisory agencies in emerging markets tend to be even more understaffed and short of resources than those in developed markets. Importantly, most supervisors in emerging markets have a background in accounting or economics -- sorely lacking are examiners who have solid experience in risk management, risk-based supervision, political science, financial modeling, or even finance, all fields that are very useful for good on-site and off-site bank exam teams.

Exhibit 4: Banking Return on Asset Ratios (*Source: Fitch)*



Many emerging market supervisors are either compliance-based or in transition to a risk-based supervisory framework, which, while imperfect, is a better framework to supervise whether banks are adequately capitalized to supervise unexpected losses. Investing in or being a counterparty to emerging market banks requires good due diligence that cannot be outsourced to anyone. Yet it is in those banks that growth opportunities lie for the next decade -- at least.

Mayra Rodríguez Valladares is Managing Principal of MRV Associates and is on the faculty of The New York Institute of Finance.

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