INTERNATIONAL EXPOSURE OF FRENCH BANKS: BALANCING OPPORTUNITIES AND RISKS

As a number of European banks was touched by the American subprime crisis, there is a new urgency to consider the pros and cons of the ongoing globalization of the banking sector. In this letter, we aim to describe foreign exposures of French banks and compare them to the situation in other developed countries. Foreign subsidiaries and branches of French banks have brought them new sources of profits. However, these profits appear to be more modest when we consider higher risks of investing in countries with unfamiliar cultures, poor quality of institutions and uncertain business environment. In addition, the globalization of banking has diminished the benefits of diversification and has increased the risks of contagion.

Foreign claims (loans made and deposits placed abroad) of banks and financial institutions reporting to BIS have grown spectacularly in the last decades. They have more than tripled after the introduction of the Euro and in 2007 amounted to USD 25 trillion. Forty percent of these claims are held by international banks headquartered in Germany, United Kingdom, and France (15, 13 and 12 percent, respectively). Foreign claims of French banks have grown at the same pace as total foreign claims in the last decade. At the end of 2006, they amounted to 48 percent of total banking assets in France, which is above the average for other internationally active banks (40 percent). Curiously, French banks’ exposure towards the Western European countries has grown slightly less than their exposure towards the US, which has quadrupled since 1999 (Figure 1). Most of the increase in foreign claims took form of cross-border claims, i.e. claims of international banks on non-residents, granted and overseen either by the head office without the physical presence in the country of the borrower, or via a representative office. However, more recently international banks decided to enter markets by establishing branches and subsidiaries in other countries. These local claims have constituted only 8 percent of total foreign claims twenty years ago, but have grown to 33 percent in 2007 (37 percent in France).

The presence of international banks, including French ones, is particularly striking in the Central and Eastern Europe. In the 1990s, banking markets were liberalized in this region, and international banks established greenfield operations which mostly targeted large international and domestic companies. However, during the privatization process, they have acquired large domestic institutions and currently foreign investors control over 80 percent of the banking assets in the new EU countries.

Figure 1 – Foreign claims of French banks
(billion dollars, 1999-2007)

Source: BIS.

1. The BIS data covers institutions in the following reporting countries: Australia, Austria, Belgium, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Greece, Hong Kong, India, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, Norway, Panama, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan, Turkey, the UK, the US.
2. The BIS data only considers claims of branches and subsidiaries in local currency as local claims. Since large part of claims is extended in foreign currency, the share of real local claims in all currencies is higher.
member states. This allows international banks not only to extend claims on non-residents, but also to collect deposits, thus fully competing with domestic banks in these countries. On the other hand, this also involves a higher commitment since it is much more costly both financially and politically to close operations of a subsidiary than to refuse to roll over a foreign loan.

Why do international banks go where they go?

In order to benefit the most from their internal knowledge advantages (technical, marketing and managerial know-how), banks are better off investing in countries that are similar to those they are already familiar with. This explains why French banks chose to invest primarily in developed countries, and particularly in other EU countries, which form the Single Market for Financial Services since 1993 and, for most of them, the Eurozone since 1999.

At the same time, we can observe that profits of foreign banks in developed countries are lower than profits of domestic banks in the host countries. It reflects high level of competition in these markets, which leads to high costs for foreign banks that try to penetrate them. This motivates international banks to expand to developing countries, where expected economic growth is higher than at home, and where they can additionally benefit from local banking systems’ inefficiencies. When deciding to which developing country to expand, common language and history play a crucial role, as this increases the familiarity of banks with the local conditions. Thus, French banks expand to African countries, Austrian banks control large shares of the Central and Eastern European banking industry, Spanish banks implant in Latin America, and Scandinavian banks in Baltic countries.

Table 1 shows main regions of operations of French financial institutions. As mentioned earlier, French banks primarily enter developed countries. Most of their activity takes form of cross-border claims, but French banks also control large banks. For example, BNP Paribas owns BancWest in the US and in 2006 it acquired BNL, the sixth largest bank in Italy. This last acquisition was one of the largest deals in the EU in the last years and has driven the claims of French banks to 26 percent of the total foreign banks’ claims in Italy. This increases the familiarity of banks with the local conditions. Thus, French banks expand to African countries, Austrian banks control large shares of the Central and Eastern European banking industry, Spanish banks implant in Latin America, and Scandinavian banks in Baltic countries.

Outside of developed countries, French banks have particularly large stakes in the banking sectors of Central and Eastern Europe. They have decided to enter new EU member states relatively late, hence they control smaller shares of the banking sectors than Austrian, Italian or Belgian banks. Still, Société Générale controls the second largest banks in the Czech Republic (Komercni Banka) and Romania (BBR). Other French banks, such as BNP Paribas and Crédit Agricole Group have chosen to establish only small greenfield banks to serve certain niches in the market. However, recently BNP Paribas has adopted a more aggressive strategy and has acquired UkrSibbank, the third largest bank in Ukraine.

In Asia, French banks have mostly been present in form of cross-border loans. French banks do not have any stakes in the “big four” state-owned Chinese banks, which were partly privatized in 2005-2006. Instead, in 2005, BNP Paribas has chosen a less risky strategy and acquired a 19.2 percent stake in the Bank of Nanjing, a much smaller city commercial bank. This poses less risk for the bank, since it is much easier to reform a small bank than a large one, and there is less risk of interference from the government.

Because of historical links and common language, French banks are among the main investors in banking sectors of African countries. If we exclude South Africa, where British banks’ presence is significant, France becomes the largest investor. French banks are represented in the North and West of Africa. In some countries, the ratio of claims of French banks to domestic credit is very high: 25 percent in Czech Republic, 33 percent in Romania, or 20 percent in Morocco where, moreover, assets held by French banks account for 80 percent of the total foreign banks’ claims in this country. Such structure of credit renders these countries dependent on investment decisions of French banks. Among developed countries, French banks appear to be very important for the Italian economy.

Opportunities and risks abroad

Banks decide to expand abroad in search of profits. Therefore, we look whether this strategy pays off. For this exercise we use BankScope data on French banks’ branches and subsidiaries located in the world and compare their performance with that of

| Developed countries | 2.716 | 85.2 | 10 |
| United States | 654 | 22.1 | 10 | 5 |
| United Kingdom | 432 | 15.3 | 11 | 9 |
| Italy | 337 | 11.4 | 26 | 13 |
| Emerging Europe | 99 | 3.4 | 9 |
| Czech Republic | 26 | 0.9 | 20 | 25 |
| Romania | 14 | 0.5 | 15 | 33 |
| Russia | 9 | 0.3 | 6 | 4 |
| Asia | 75 | 2.5 | 7 |
| South Korea | 50 | 1.7 | 9 |
| Hong Kong SAZR | 25 | 0.9 | 7 | 9 |
| Singapore | 16 | 0.5 | 8 | 12 |
| Africa | 52 | 1.8 | 23 |
| Morocco | 14 | 0.5 | 82 | 20 |
| Egypt | 7 | 0.2 | 27 | 6 |
| Tunisia | 5 | 0.2 | 67 | 19 |

How to read the table: Claims of French banks on the US (654 billion US dollars) represent 22 percent of their total foreign claims. This constitutes 12 percent of the total foreign claims of all foreign banks on the US, and this equals to 5 percent of the US domestic credit.

Source: BIS.
Western Europe is particularly interesting. We observe that the situation of French banks that invest in other countries of Western Europe earns higher returns. Therefore, it is essential to look at the risk-adjusted profits. To calculate such indicators, we divide ROA and ROE by the corresponding measures of risk, computed as standard deviations of ROA and ROE for the period between 1995 and 2005. Our results show that risk-adjusted profits of banks located in Western Europe are often higher than those of French banks located abroad. In terms of risk-adjusted ROE, only banks located in North Africa earn higher returns.

The situation of French banks that invest in other countries of Western Europe is particularly interesting. We observe that returns are much lower and risk is higher in this region than in North America. The results for North American branches and subsidiaries are clearly driven by the US banks and we see that profits there are high when they are calculated as a share of assets, but due to high capitalization, return on capital is much smaller. Profits of European subsidiaries might increase in the future, when there is more integration in the European retail market, which is characterized by lower variability of profits than investment banking. Acquisition of the Italian ENI by the BNP Paribas could be one of the steps in this direction. However, the choice of the target bank is questionable, since Italy has lagged behind other EU countries in terms of growth in the last years and its long term growth perspectives are weak.

### Diversification and contagion

Despite high individual country risks, French banks can still benefit from diversification of their revenues across different geographical regions. By having smaller exposure to home market conditions, they are less affected by local shocks. There exists empirical evidence showing that during economic downturns in home countries international banks increase their lending abroad, where economic conditions are better and growth is higher. Moreover, by expanding to several geographical regions, banks can better insulate their revenues from shocks occurring in one part of the world. The diversification gains are the largest when correlation between economic cycles in the regions is the smallest. In the last decade, business cycles of industrial countries have become very interdependent, and correlation between GDP growth within them amounts to 41 percent. However, business cycles of industrial and emerging markets are still little correlated (12.6 percent), particularly so in African and Middle Eastern countries (8.5 percent), one of the destinations of investments for French banks.

International banks from industrial countries can have diversification gains from investing in emerging markets. But at the same time, diversification can also cause problems as parent institutions can lose “focus” when they diversify too much. Empirical evidence on the positive relationship between bank diversification and financial performance is rather weak. Therefore, one should carefully balance benefits from diversification and costs from investing in too many countries. In order to measure diversification, we look at the shares of each region in the total foreign assets of international banks. In addition, we calculate Hirschman index, the sum of

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3. We use BankScope database which provides information on balance sheets and income statements of branches and subsidiaries. We rely on unconsolidated statements for French banks located in France and consolidated statements for branches and subsidiaries of French banks abroad. Since BankScope provides an incomplete data on bank ownership, we complete it with information obtained from webpages of largest French banks.

the squared shares of country's foreign claims across countries. A lower index indicates a higher diversification of foreign assets. We compute three different indices: for the whole world, developed countries, and developing countries. We compare our results for France with findings for other major financial centers in Europe and the US (Table 3).

In comparison to other financial centers, foreign claims of French banks are well diversified, particularly so in developing countries. The UK and Spanish banks appear to be the least diversified, with large exposures to the US and Latin American markets, respectively. Spain and Austria, with 11 percent and 9 percent of their total foreign claims in Mexico and the Czech Republic, respectively, are the most exposed to individual developing countries. In contrast, France and Germany do not have exposures to individual developing countries above one percent, and the largest exposures of UK and US banks amount to 5 percent in Hong Kong and Mexico.

At the same time, French banks are more exposed to the US market (22 percent) than banks from other European countries, with the exception of the UK (35 percent). Historically, this appeared to be a good strategy: we showed earlier that risk-adjusted returns were larger in the US than in Western Europe and many developing countries. However, this can lead to some losses as the current financial crisis illustrates. As it was mentioned earlier, BNP Paribas has a large subsidiary in the US. Even though it has a limited exposure to subprime loans, which constitute only 2 percent of the total individual mortgages, it can still be affected by the recession in the US and the contagion.

It is too early to make conclusions about the current situation, but we can look at the experience of international banks in the past, particularly in the wake of previous crises. There is a consensus among economists that contagion between financial centers has increased recently, but the findings on its direction are less conclusive and differ depending on the methodology and analyzed period. One study finds that French banks are on average less sensitive to contagion than other European banks; they experience contagion from Spanish banks only. At the same time, a more recent study places Société Générale (along with Deutsche Bank and ING) among European banks which are the most vulnerable to contagion risk from other major international banks.

It is exposed to shocks that affect international banks located in the US, Switzerland and Netherlands. BNP Paribas is more insulated from shocks to any particular country, probably due to better diversification within businesses and countries. In turn, this study shows that shocks to Société Générale have the widest impact on banks in continental Europe, while there is a growing contagion risk from BNP Paribas to the UK and US banks.

To conclude, we argue that the globalization of banking brings higher profits, but it involves new risks, increases contagion and diminishes gains from diversification. An additional effect of globalization is the growth of gigantic banking institutions, which are very difficult to manage and supervise. Market discipline weakens as well, because markets expect a bail-out of institutions which have grown "too big to fail". This distorts incentives of managers to carefully consider the trade-off between risks and profits and leads to under-valuation of risk, which we observe in the current subprime crisis.

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