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International diversification gains and home bias in banking

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ABSTRACT

This paper studies international diversification in banking, exploiting a bank-level dataset that covers the operations of 38 global banks and their subsidiaries overseas during 1995–2004. The paper finds that banks with a larger share of assets allocated to subsidiaries in emerging market countries were able to attain higher risk-adjusted returns. These gains were somewhat reduced by the concentration of bank subsidiaries in specific geographical regions, which is typical of the observed international expansion strategies. The paper also finds a substantial home bias in the international allocation of bank assets relative to the results of a mean–variance portfolio optimization model.

1. Introduction

Financial globalization since the mid-1990s produced a large increase in cross-border merger and acquisitions in the banking industry and a massive expansion of bank activities overseas. Between 1990 and 2006, the foreign claims of BIS-reporting banks (which include cross-border lending and the local activities of their subsidiaries overseas) doubled from 1.3 trillion US dollars to 2.7 trillion US dollars (Fig. 1). Arguably, these globalization trends generate potential risk diversification benefits for banks with international operations: since business cycles across countries are not perfectly synchronized, a bank with broad global exposures should be better positioned to diversify away country-specific risks.[2] International diversification in banking, however, is barely understood, as shown by the fact that it is not taken into account in capital charges for credit risk under Basel II and forthcoming Basel III (Basel Committee on Banking Supervision (2003, 2004, 2011)).

Following the pioneering work of Markowitz (1952, 1959) on portfolio optimization and early extensions to the international context by Grubel (1968), Levy and Sarnat (1970), and Lessard (1973), a large body of literature in finance has studied the effects of international diversification in securities portfolios. Not surprisingly, the gains from international diversification in securities portfolios have been found to be large, albeit not fully exploited by investors due to the so-called ‘‘home bias’’—an overinvestment in domestic securities relative to the efficient benchmarks first noted by Kenneth et al. (1991).[3]

A parallel literature addressing the benefits of geographical diversification in banking is only incipient. A few studies have focused on the benefits of *local* geographic diversification (i.e., diversification between regions in a given country), yielding inconclusive results. For example, Morgan and Samolik (2003) found that broader geographical presence of banks within the United States was not associated with higher returns or lower risk. Similarly, Acharya et al. (2002) concluded that local geographical diversification of banks within Italy was not clearly associated with improved risk-return trade-offs. These findings suggest that the

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[2] Separation theorems in finance imply that banks operating in a frictionless world should focus exclusively on profit maximization, leaving portfolio diversification to their shareholders. However, the existence of prudential regulations, taxes, bankruptcy costs, and informational asymmetries may justify an active management of risks by banks (see for, example, Diamond, 1988).

[3] There is evidence that the home bias puzzle in securities portfolios has been decreasing over time, Amadi (2004).

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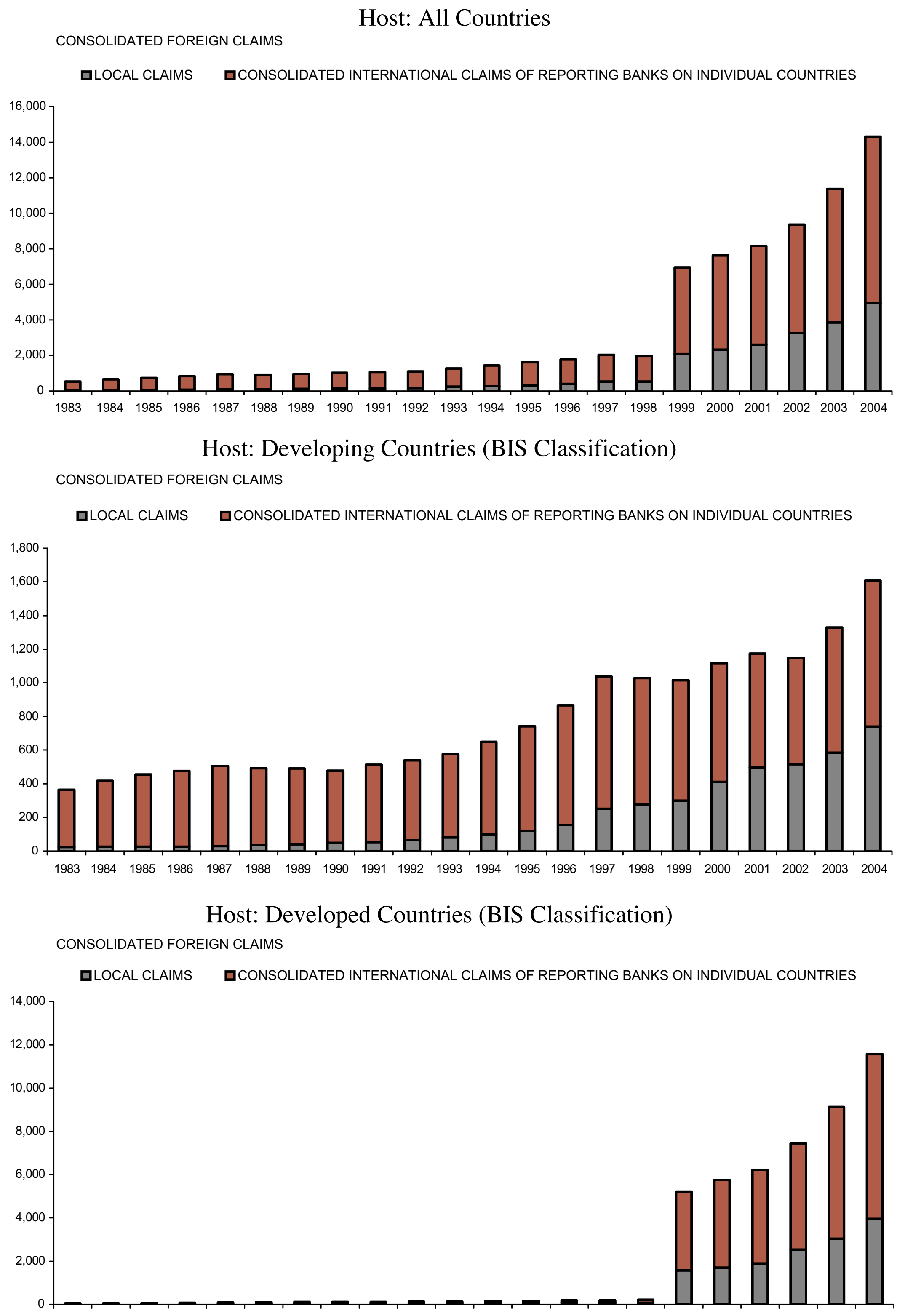

Fig. 1. Evolution of local and cross-border claims of BIS-reporting banks, 1983–2004. In billion US$ 1/. 1/ There is a break in the series in 1999 due to a change in definitions. Source: Bank of International Settlements

benefits of local geographical diversification may be limited, a result possibly due to the strong co-movement of macroeconomic variables between regions in a given country.

As regards *international* geographical diversification, Griffith-Jones et al. (2002), showed that the synchronization of business cycles was higher between industrial countries than between emerging market countries. They also showed that the synchronization of economic activity between industrial and emerging market countries was generally low. On that basis, and the fact that banks carry a considerable degree of country-specific risks in their credit