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EXPORT OF SERVICES: HYPE OF HIGH POTENTIAL? IMPLICATIONS FOR STRATEGY- MAKERS

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Exporting Financial Services from South to North: Hype or Reality?

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"Arguably, the greatest step our governments can take to generate increased growth and poverty reduction is through the removal of trade barriers under the Doha Round negotiations.

Liberalization in services could deliver some of the greatest gains from the Doha round and is an essential element to the DDA. The income gains from services trade have been estimated to be much greater than from the liberalization of goods alone. *The World Bank estimated that if developing countries were to liberalize four key infrastructure services they could, by 2015, generate income gains four and a half times greater than the gains from goods liberalization alone*.

Financial sector liberalization is particularly important for economic growth and poverty reduction, yet the quality and quantity of offers made has been extremely disappointing. Without a change in course, we are concerned that the Doha round could generate almost no new liberalization in trade in services -- a missed opportunity for development and poverty reduction. Therefore all countries, but especially developing countries which stand to benefit the most, should make WTO commitments to provide effective market access in services, including financial services.

U.S. Treasury Secretary John W. Snow, Development Committee Statement (September 25, 2005)" (http://usinfo.state.gov/usinfo/Archive/2005/Sep/25-121095.html⊥)

Can financial service firms from emerging markets compete and benefit from serving clients in the developed world? A dominant view is that no real strategic opportunity exists for developing/transition economies to export financial services. That view is challenged here by pointing to examples in which this is already occurring, and to strategies which are being employed to do so.

Many economists agree that global trade connects buyers to the most efficient sellers of goods worldwide. Under the right conditions, this trade has benefited many developing countries in achieving growth and reducing poverty, with trade in goods leading the way. At the same time, in the developed world, the service sector has emerged as the largest supplier of jobs, growth and innovation. Developing countries possess a natural advantage in labor intensive manufacturing and trade for many goods. Services, on the other hand, are largely technology and infrastructure dependent (with the notable exception of certain labor intensive services such as construction and data processing). As the service sector expands globally, how will developing countries adjust to and benefit from newly forming, or reforming, global service markets?

Unique amongst services in both size and complexity is the financial services industry. Financial services are the largest industry in the world measured in earnings. The services provided by the industry broadly fall into the categories of banking, insurance, brokerage houses and investment banks. Sub-industries populate each of these broad categories, each in some way providing specialized forms of capital products and related services. These include: transactions services (i.e., trade finance), trading and derivatives, debt & equity structuring, asset management, debt and equity financing, advisory and insurance.

In an increasingly linked global economy, clients will flock to the most efficient suppliers of goods or services. In practice, trade liberalization in the financial sector has resulted in many emerging markets, to varying degrees, opening their financial sector to foreign firms. But are financial services part of a global market in which financial products will move North with the same ease with which they have customarily moved South? If so, the consequences for growth of financial services in emerging markets will be enormous. What needs to be done by emerging market industry participants to make this happen?

1 Financial Services Seen Globally

Two critical success factors of the financial services industry, enjoyed by market leaders, are size (i.e., market capitalization and assets) and complexity (i.e., technology, risk management and data volume). Neither plays to the strengths of most developing economies. Although the industry is highly fragmented, size does matter. The ability of a Citigroup or an HSBC to serve customers across the globe seamlessly is a major competitive advantage. Complexity is also a hindrance to firms from developing countries, as the industry becomes more reliant on advanced information technology to manage risk and, with the advent of Basle II, to comply with regulators.

One of the problems in assessing the potential for export of financial services lies in its definition. What does it mean to export a product whose very nature is fungible, liquid and which has always resisted the confines of national borders. How do you “trade” in these services? Does trade simply mean allowing cross-border provision of financial services or establishing a foreign commercial presence? Or does it extend to allowing companies and individuals in one country to tap liquidity from another country without restriction? What is being traded, expertise, risk or capital – or all three?

The gushing advances of the technological revolution of the nineties were liquid fuel for the financial services industry. Soon, capital made its way from New York, London, and Tokyo to emerging markets such as Thailand, Korea and Malaysia and elsewhere in the blink of an eye. But those same technological advances were not evenly spread: in the absence of advanced risk management and credit analysis capabilities (factors of market complexity) in host markets, this sudden surge of capital proved unsustainable and eventually catastrophic.

A decade later, in the wake of the technology boom/bust wave, the financial services industry has been transformed once again by technology. Now the industry is trending towards consolidating formerly separate sub-industries (banking, brokerage, insurance, etc.) into highly branded, individualized product offerings. Will financial institutions based in emerging economies be able to provide such products to clients in developed countries? And if so, what factors found in many emerging markets will drive this market expansion? Will these products only make sense from the perspective of trade finance? Or can they be disassociated from regional trade or, for that matter, from regional financial markets? These are only some of the questions that need to be answered in the process of strategy formulation.

2 Strengths and Weaknesses for Market Entry

Before looking at strategic options, it is worthwhile taking stock of some of the challenges and opportunities facing many financial service institutions in emerging economies as they expand into developed economies:

Strengths that some emerging market banks have:

Excess liquidity in home markets (need for asset growth)
Global client relationships (usually related to trade in commodities or goods)
Large home based market shares and market knowledge

Weaknesses:

Excess liquidity in home markets (symptom of weak markets)
Limited foreign currency reserves
Weak credit analysis capabilities
Weak risk management capabilities
IT infrastructure gaps
Information asymmetries regarding global markets
No market presence or brand identity in developed economies

3 Overcoming Weaknesses to Forge Winning Strategies

Following the Gramm-Leach-Bliley Act of the late 1990s, which enabled different types of companies in the US financial services industry to merge, firms generally followed one of two strategies in order to consolidate activities and gain market share. The first was for a bank to simply buy existing brokerage, investment banking or insurance companies, without changing brands. The second strategy was to build new companies from the ground up and to create a unified branding strategy. Under this strategy, new products would be sold to a pre-existing customer base (increasing the wallet size).

Financial service firms from emerging markets wishing to trade in developed markets are faced with different strategic challenges and options. Buying vs. building are indeed available options, but they are complicated by the weaknesses noted above. However, as we shall see below, there are successful examples of firms based in emerging markets that have followed similar strategies.

One such example is that of the Dominican Bank, Banco Popular. This bank had a very obvious reason for establishing a brand presence in the United States: over one million Dominican expatriates live there, the majority in the New York City area. In 2004, Dominican immigrants sent home a record volume of $2.7 billion in remittances, representing over 15% of the nation’s gross domestic product. From this base, Banco Popular has issued over $6.5 billion in personal, mortgage and retail loans. In addition to the bank, it has established Popular Leasing USA (over $300 million in assets), Popular Cash Express (check cashing and transfers), and Popular Mortgages USA.

Many countries with large emigrant populations will find the Banco Popular model to be a logical strategic option for expanding trade in financial services in the developed world. Countries such as Senegal and Mali have large overseas populations that remit millions of dollars annually. Channelling that money through local branches of existing banks (Banque de l'Habitat du Sénégal, for example) into defined products such as mortgages to pay for homes in either country is a viable strategy for market expansion.

Another bank, Thailand's Kasikorn Bank, is on the cusp of expanding its global network in retail banking, trade finance and investment banking. With 496 branches, including Honk Kong, Shenzhen, Los Angeles and the Cayman Islands, it has over $4 billion in assets under management. Kasikorn weathered the collapse of the Baht in the nineties to emerge intact and invest heavily in modernizing its technology infrastructure and risk management capacities. As a result, it has eliminated many of the competitive disadvantages still facing many emerging market based financial institutions in their bid for expanded market reach.

China, on the other hand, has the equivalent of $2 trillion in domestic bank deposits. The Chinese government has not yet signalled how or when they will expand the global reach of their financial services industry. However it has recently permitted some firms, such as insurance companies, to invest assets abroad. In one important respect, China is already a major emerging markets exporter of financial services, in that it sells liquidity to US money markets. Currently, China is the second largest holder of US Treasuries in the world, after Japan, with $243 billion in its portfolio as of June 2005. Whatever expansion strategy China chooses to adopt, size will not be its strategic challenge; instead it will confront issues revolving around market complexity (technology, risk management, credit analysis, etc).

An alternative to building a new brand identity in developed markets is for new entrants from emerging countries to pursue partnership arrangements that achieve all parties' strategic objectives. So if a bank in a country with excess liquidity and currency hedging needs, for example, wanted to place long term currency swaps with a global bank in search of the same, a partnership arrangement could be struck that would be invisible to the end user.

An example of this was recently introduced by a leading global bank, under the banner "Borderless Banking".

"The concept of 'Borderless Banking' […] promotes the idea that banks do not have to build everything themselves, something that many banks have fallen foul of. Everyone has their own proprietary systems, but our thinking is that banks can work together to fill product gaps, extend market reach and solve infrastructure problems by working with partners. For example, if we have a product that [Bank B] does not, we can white-label it as their product and vice versa."

- Trade Finance Magazine, September 2005

The concept of partnering to fill product and brand gaps, extend market reach and solve infrastructure problems is a powerful tool for introducing trade of financial products across borders. The benefits are most obvious with products that are themselves traded, such foreign exchange, derivatives, swaps, commodities, futures, etc. The market potential for these products is enormous: the "gateway" product of foreign exchange is part of a global market that generates $1.5 trillion in daily volume. This is more than the combined volumes of the NYSE, FTSE, Nikkei and DAX.

A broader question is whether excess liquidity in a country's banking system can be re-engineered as an exportable product? Most emerging markets have significant stores of excess liquidity. Will innovative banks be able to channel this supply of excess liquidity into an internet-driven "Borderless Bank" global pipeline capable of delivering products anywhere? Will it be possible to "in-source" liquidity and, eventually, even credit products into a global money market? Will regulatory authorities be confident enough in their advanced risk-based oversight regimes, based on Basel II, to enable such innovation?

And to what extent will a partnership strategy work for less liquid classes of products, such as insurance, brokerage and even advisory? Is it possible for investment banks to outsource due diligence, structuring or capital raising?

Finally, it should be noted that just as technology is changing the shape of financial services, it is also changing the fundamental nature of markets. We are now entering an era of virtual markets that offer virtual products, or more precisely, digital products. One good example of this is a new internet based exchange, called Arbinet, for trading voice traffic worldwide between telecommunication carriers. In this example, carrier capacity is bought and sold in a liquid environment and netted between market participants all across the globe, relying on credit lines to back trades. Calling capacity traded on this exchange originate and terminate in every country in the world, and innovative financial service companies, regardless of location, will find a way to match their credit issuing capacity to this traffic.

The potential for trade of financial services provided by emerging market actors in developed markets inevitably leads to more questions than answers. What is clear is that there are many challenges to overcome, and that no one strategy will fit all. But it is vitally important that emerging markets actors benefit from the liberalization of financial services that is underway. As daunting as the competitive challenges are, with vision and innovation, they can be overcome. In the long run, strong partners on both ends of the trade equation increases value for all.