OPERATIONAL RISK AND FDI IN THE BANKING SECTOR

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Abstract: : In general, the academic literature has paid its attention to market risk and credit risk and ignored operational risk, an "umbrella" term that includes problems with information systems, operational problems, breaches in internal control, fraud, or unforeseen catastrophes such as 9 - 11 or SARS. The negative impact of operational risk on banks net profit, lead to the conclusion that operational risk is to be considered one of the key drivers for future profits. Analyzing information provided by financial institutions and empirical experience, the paper concludes that not only there is a strong connection between the FDI and operational risk but the link between the two has a double sense of "incentive — effect", one is influenced by the other and vice-versa.

JEL classification: G11, G21, G32

Key words: operational risk, foreign direct investments, banking sector

1. INTRODUCTION

Despite the number of challenges facing the banking sector, opportunities for growth are plentiful, particularly through expansion in new markets. Mergers and acquisitions, as primary catalyst for global FDI flows, are the most used forms of banking investment and the paper will consider this particular fonn of FDI for analysing the relations with operational risk.

The objective of this paper is to establish the degree and the direction of empirical connections between the causes and materialized forms of operational risk and foreign direct investments in banking sector. The paper is structured into two main parts. A detailed description of operational risk and its impact on banking activity is presented in the first part. The second part illustrates the double sense of "incentive - effect" connection between operational risk and FDI. Both, positive and negative, effects of this relationship are captured in order to have a detailed picture of the

possible link between operational risk and foreign direct investments. The final part concludes.

2. OBJECTIVES

The global banking sector is and will remain extremely competitive in the coming years, partly due to the structural issues, low growth and inflation. In terms of consolidation, the global banking industry, one of the least consolidated industries in the world, will expand to the forecasted point where the top three competitors will control more than 30% of global market share (more than three times the current level).

3. METHODOLOGY

A. FDI's role in banking sector

Mergers and acquisitions, as primary catalyst for global FDI flows, are used by banks as inorganic growth strategies to achieve their goals. Encouraged by falling cross-border investment barriers, banks will expand abroad by acquiring or merging with banks in other countries. Accounting for about one-third of global M&A volume, the mergers and acquisitions in financial institutions is expected to remain relatively high in the next several years as the consolidation process will deepen. The main reasons why banks use M&A as growth strategies include the desire to improve competitive position, to target new customers and to avoid the cost of start-up business building. Even though, ideally, banks prefer growth in an organic form, mergers and acquisitions will remain an important part of their growth plans, most of these transactions being targeted at filling geographic gaps.

B. Operational risk influenced by FDI

The following paragraphs will present the impact that FDI lias on the banking system in terms of managing the operational risk. Both, the positive and negative influence of the FDI will be highlighted, in order to offer a better look upon different aspects of the influence that FDI have on operational risk. Intensified competition, improved availability and quality of banking services, technology transfer and easier access to capita! are the main benefits associated with foreign entry into the financial systems . From the operational risk management point of view, the positive effects of FDI entry into baking systems are translated into better risk management, increase efficiency and lower costs of controlling risks, technology transfer and positive impact on banks reputation. Probably the most known and obvious effect of FDI on operational risk, the better risk management is also, on my opinion, the most important positive aspect of the foreign capital entry into the banking system. When entering into a new market, foreign banks bring into the host country various and sophisticated techniques of risk management. In terms of operational risk management, many host banks were using before receiving foreign capital injections, rudimental instruments of identifying and monitoring this particular type of risk.

Through capital flows, foreign banks are exporting the best know-how on risk management, thus offering to the host banks the possibility to use complex and efficient techniques of identifying, measuring, monitoring and mitigating the operational risk. In other circumstances, these banks will have limited or no access to these advanced management instruments. For example, the majority of the Romanian banks that will

implement the advanced versions of Basel II approach for capital adequacy on operational risk, have totally or majority foreign capital[1].

Deriving from the first effect of FDI presented, the improved risk management will generate a reduction in costs and losses produced by the materialisation of operational risk. The decrease in costs and losses are the reflection of the positive synergies induced by the M&A, As presented above, 15% is considered the average impact of losses due to operational risk on operating profit , but this percentage is much higher in the absence of complex techniques and methods of risk management.Besides the measurement of actual or expected operational losses, banks will have to measure the unexpected costs which operational risk will incur both from a regulatory and economic perspective. The costs of economic capital on operational risk and of the implementation of Basel II will decrease based on the complex models of evaluating and the modern techniques of mitigating the operational risk that foreign banks are providing through capital flows.

Foreign capital investments in technology have a positive impact on reducing operational risk through technology transfer. Advanced and complex IT systems, security and backup tools will lower the probability and the impact of operational risk materialized. According with an AT Kearney study, 63% of global investors indicate that they have invested in backup IT and physical infrastructure and 11 % are planning on doing so. The preferred form for this type of FDI flows is off-shoring by relocating different business processes. Because of the information-intensive character that makes it feasible to digitise numerous processes, banking industry has one of the largest IT budget. Through off-shoring, banks can save 8-12% of their overall costs, but in order to do so, global companies will need to manage effective offshore risks (complexity, compliance, culture and cost), while host countries must adapt promotion efforts to attract offshore investments. Foreign investments positive effect over operational risk management is also emphasized by the good influence on the reputation of the host banking system. The decision of top ranked banks worldwide to invest in a certain banking system is regarded as a positive evaluation of the stability and growing potential of that financial system. In exchange, a good banking reputation has a decreasing impact on operational losses through the low level of reputation loss, as indirect effect of operational risk. The negative influence of FDI on the risk management is presented by describing a series of effects that increase the level of operational risk. The forms in which these effects appear vary from the increasing exposure to reputation risk, vulnerability of the IT and operations, to generating new types of risk .

Globalisation has offered large banks the opportunity to expand abroad by acquiring or merging with banks in other countries. But, one effect of globalization is that activities and thus risks are no longer simply limited to one institution, region or country. While the outsourcing and off-shoring of activities has reduced the exposure to risk for many institutions, it has created risk elsewhere so that the overall risk for a system has increased or maintain at same level through diversification and diffusion of risks. Operational risk was the most affected by the globalization implications presented, because of the high percentage of the risk component in banking staff and

[1] According to a consultative paper only one bank in the system, a subsidiary of a foreign bank, will apply, starting from 2008, the advanced measurement approach for operational risk.

business functions. One of the most cited operational risks exported and amplified due to globalization and free movement of capital is information security failure.

Technology transfer has created for many host systems the premises for emerging new types of operational risks. The host banking system is not the only one affected by the globalization influence. The investing banks also have to face a growing number of diversified operational risks such as, external crime, business disruption or system failure. As banks enter new markets, maintaining their reputation has become critical. Banks view operational and reputation risk to be greater concerns than market, credit and liquidity risk, which they are generally able to manage more effectively. Reputation risk has the ability to destroy market capitalization, and in the extreme, bring down even a well capitalized institution, almost overnight, given that banking business is based on trust.

Global banks are dealing with increasing reputation risk as their products and corporate reputation became more vulnerable to attacks coming from consumer advocacy groups, anti-brand campaigns and anti off-shoring jobs movements. To mitigate reputation and operational risk, more than 60% investors say they have either begun, or plan to begin, developing new corporate social responsibility. The reputation risk affects not only the foreign banks but has also an increased impact on the host county. All foreign banks experienced a run when such smaller parent banks were closed. It had come to be appreciated that small banks in large home countries might not be systemically important, but problems experienced by them could generate significant spillover effects in smaller host countries[2]. The highest and the most diversified impacts of foreign investments are located on the operations and IT (Ops & IT) banking activity. On the operations side, the payments and settlement systems were most affected by operational risk, and on the IT side, risk increased along with the number and complexity of applications used.

The integration of host banking sectors into a globalized economy through FDI and the introduction of modern payment infrastructures, most of the time as a positive effect of foreign capital entry, will create demand and thus result in a sharp increase in transactions, both values and amounts, that need to be processed and settled through financial institutions. Such trends will have a positive effect on the use of banking system in general and the system supporting their operations. I also think that the extraordinary increase in the volume and value of transactions over the last years due to FDI flows, has not only positive aspects, but from an operational point of view, is possible also the source of more risk. Banks have become increasingly vulnerable to hacker attacks and data theft based on the huge volume of information they have to assemble on their customers for both regulatory and marketing purposes. In my opinion, major part of this situation is generated by the oversized number of application used by banks, insufficient security protection and lack of integration of different IT infrastructures. Many times, these situations are generated by the numerous acquisitions that banks have made over the years. For example, top banks actively involved in M&A are using double the number of applications utilized by regular banks to complete their work and, in many cases this is the legacy inherited from years of M&A.The operational risk profile of banks is changing as volume of payments traffic grows, as

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[6] For example, in the case of Uruguay, smaller foreign banks generated huge problems in the banking sector

more and more complex technology is used, as there is a shift from paper to electronic payments and a larger share of the population having access to banking services. In these conditions, even if risk might not increase, and automation might help reduce risks, the likelihood that an operational incident would cause more severe losses is probably higher than before.

4. ANALYSES

Researchers suggest that investors have a relatively simple check list for the key drivers that influence the FDI decision: first, political and economic stability reflected in stable and sound legal framework, clear property rights and transparent administration; second, an attractive domestic market with good potential for growth; third, the availability of skilled labour and labour productivity; fourth, access to local sources of finance. As global banks extend their operations across borders through M&A, they face an increasingly complex set of risks. Investors cite a range of critical risks to their operations that influence their decisions. Among the most critical operational risks to banks, the following have an important impact on investors: terrorist attacks (22%), security threats to employees and assets (21%), IT disruptions (17%), employee fraud or sabotage (8%).

One in five investors cites security and terrorism among the most critical operational risk to their company. Empirical evidence indicates that terrorist risk depresses net foreign investment positions. Reducing the expected return to investments and increasing uncertainty, terrorism have a large impact on the allocation of capital across countries, even if it represents only a small fraction of the overall operational risk. Changes in the intensity of terrorism may cause large movements of capital across countries[3] if the world economy is sufficiently open, so international investors are able to diversify other types of risks. Higher levels of terrorist risks are associated with lower levels of net foreign direct investment positions, even after controlling for other types of risks. In response to these operational risks, most investors are developing and strengthening internal risk management systems, investing in backup IT and physical infrastructure, implementing new corporate social responsibility strategies or creating new branding strategies in response to anti-corporate public sentiment.

5. CONCLUSIONS

Operational risk has a different impact on financial institutions involved in foreign capital investments, on one hand the banks that are investing through mergers and acquisitions, and, on the other hand, the institutions in the host country. On the host banking sector level, foreign direct investments have a positive impact by reducing the overall operational risk through implementing and improving better operational risk management models and techniques, and by increasing technology transfer and sustaining good reputation of the host banks.

For banks that generate capital flows through mergers and acquisitions, FDI have a different, negative, impact by increasing their exposure to operational risk. Increasing the level of reputation risk, vulnerability of the IT and operations systems, the surface of new types of risk, are forms in which operational risk affects banks that invest abroad. In this case, one question arises: Why then banks still invest through

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[3] A standard deviation increase in the terrorist risk induces a fall in the net foreign direct investment position of about 5% of GDP.

M&A despite of the possibility to expose themselves to a higher operational risk? The answer comes naturally: because is worthy doing so! The high profit resulting from the M&A is a powerful incentive for banks to continue their expansion through investment activity. In response, these banks are covering the higher operational risk not only with the increase in profits but also with the implementation of new strategies and tools aiming to mitigate the overall risk.

A special case is to be considered the situation when the M&A involves two banks with a similar market position. Regarding this situation, I consider that both banks can benefit from the improvement in operational risk management and the other positive effects resulting from it. Because of its special characteristics, the management of operational risk involves a variety of internal control flows and processes that are continually upgraded and shaped to the new-distressing situations that banks have to cope with. The models banks use require important databases of operational events recordings and other related banking information. If there are two different risk management policies, both very competitive, the merger will only bring the best out of the two. For example, when M&A is motivated by the gain of a strategic market position, the bank active in that market can provide vital information about the operational risk profile of that particular market, while the bank interested to expand can offer advanced risk management tools to process the information. The better operational risk management in this case, refers to the improvement in the quality of the operational risk management tools. Banks are better prepared to face the additional operational risk that the M&A process imply. Analyzing information provided by financial institutions and corroborating them with empirical experience, I conclude that not only there is a strong connection between the FDI, in the form of mergers and acquisitions, and operational risk but, the link between the two has a double sense of "incentive - effect", one is influenced by the other and vice-versa.

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