THE DANCE OF DUPLICITY IN EMERGING MARKETS: USING BANK REGULATION AND DEPOSIT INSURANCE PROTECTION TO ENRICH THE ELITE

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Abstract

We seek to identify the culpability of banks in resource misallocation in Mexico, Thailand and Turkey. Specifically we provide evidence of an agency problem in the government and banking systems of the three countries. Where governments pass laws and regulations consistent with modern capitalism for the purpose of deceiving investors and others, the door is opened to the use of deposit insurance and repeated promises of regulatory reform to transfer wealth from the efficient to the corrupt.

Keywords: bank risk management, value at risk, emerging markets, arbitrage, agency problems

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1. Introduction

Are there statistically identifiable impacts of bank decision-making upon resource misallocation in Mexico, Thailand and Turkey? We will present evidence that the banks' portfolio management policies during the approximately twenty year periods from the 1990's to the present in the three countries were characterized by policies counter to the interest of the taxpayers who insured bank deposits and the public stockholders of these closely held financial institutions. We argue that the banks could not have sustained their abuse of their stockholders and depositors without the support of duplicitous government promises of regulatory reform.

Elsewhere we document the argument that arbitrage has been generated in these markets as a result of a wedge that corporate corruption has driven between the value of corporate assets and the market value of liabilities and claims of these same corporations (2005a.) Importantly, we show that the necessary condition that the average investor was deceived about the sustained and continuing nature of this corruption is met. Here we focus on the importance of corruption and government support of corruption, in the form of repeated duplicitous regulatory reforms.

We address here the banks' apparent role in generating investment funds for high risk-low return borrowers in the three countries. We produce evidence that the banks' decisions were counter to stockholder interest and inconsistent with banking regulation designed to protect insured depositors. Thus there is an agency problem in these banking systems and in the governments claiming to regulate them.

Excessive dependence by government on debt finance is an apparent important source of the weak performance of the private sector in the three markets. However government debt cannot itself create loss-making private sector investments. Bank policies resulted in greater availability of funds to the private sector than economic conditions warranted, creating wealthy corporate leaders in the countries, but in the end generating massive losses for investors in the companies' liabilities and claims and for taxpayers.

This article fits comfortably within a nascent literature analyzing the financial market effects of laws and regulations found in many emerging markets globally that are consistent with financial market liberalization but are side-stepped to meet opaque asset allocation objectives not consistent with sending resources to their most efficient uses. (c.f. Bhattacharya and Daouk, 2002 and 2004, and Peek and Rosengren, 2001 and 2004.)

A second objective of the paper is to seek evidence whether the recent global reform effort that has resulted in new banking regulations governing risk management practices in the three countries has

generated a pattern of reduced risk seeking behavior there, or instead has simply been yet another public relations initiative design to lead more investment lambs to the slaughter. We find that the hypothesis of less riskiness is rejected.

Together the evidence suggests that the banks of these three countries have been grossly mismanaged throughout the data sample period, frequent regulatory "reforms" notwithstanding.

The method of this article is to identify the risk decision-making process of the banks as market investment returns characterize it. We begin our procedure by describing a simple way of identifying the total riskiness and the sources of riskiness to which financial institutions are exposed, based on a distinction between two types of risk, portfolio and position risk. We define portfolio risk to be risk due to choice of relatively risky investments; and position risk, risk due to excessively large total holdings of securities. We find evidence that by both measures banks in the three emerging markets take excessive risk while banks in Germany avoid portfolio risk and take less position risk than their three emerging market brethren. Total riskiness in the three duplicitous markets is between three and six times the risk that the Basel Accord-motivated strategies we constructed would suggest is consistent with stated regulatory intent.

To ask whether bank portfolio choices were consistent with shareholder interests, we borrow our methodology from our general equilibrium model of financial returns developed elsewhere (Dew, 2005b.) We show that the banks in the duplicitous markets carry more exposure to high risk/low return investments than to low risk/high return investments, evidence that the banks are part of the process whereby disequilibrium risk/return tradeoffs are being generated.

The paper proceeds as follows:

1. We first introduce the theoretical, regulatory, and house-keeping issues underlying our analysis. We identify the role of this article in the general thrust of our current research, which models the forces generating arbitrage in a general equilibrium framework. Using a GARCH(1,1) model, we construct monthly dynamic estimates of the covariance matrix of our banks' investment universe over the available sample periods for each of four countries: Germany, Mexico, Thailand and Turkey.

2. Excluding the financials from portfolio choice, we use an iterative procedure to construct a set of investment portfolios that are ordered by risk, have uncorrelated returns and together can be used to construct any other choice of banking portfolio in each period. We use these portfolios to concisely characterize bank investment alternatives for the sample periods.

3. The resulting portfolios are then constrained by size to meet two bank regulation-motivated constraints, a constraint on *ex ante* variance and a leverage restriction on the ratio of assets to capital. The result is a series of regulation-consistent bank portfolio management strategies – time series of portfolio returns that are mutually uncorrelated and representative of returns to all bank regulation-consistent investment alternatives in each sample period.

4. We then identify bank portfolio selection risks based on a comparison of the risk-compliant alternatives constructed above with actual bank investment performance using a regression analysis of financial institution investment returns. This comparison gives us insight into the extent of financial investment risk-taking and the wisdom of the choice of investments made by the banks from stockholder's point of view during the sample period.

2. Theoretical and Data Considerations

Our analysis in this article depends upon the concept of Value at Risk. Banks and bank regulators in these and other countries globally have participated in a series of banking reforms over the past few decades designed to meet the concerns created by banking crises that have recurred throughout the world over the past thirty years. The new method of risk management upon which these reforms are based is characterized by measurement and control of the single period anticipated variation in financial values, a process known as Value at Risk analysis.

Value at Risk analysis, as it taken shape in banking, has basically become a regulatory and accounting concept. It bridges a gap in the line of communication between bank insiders and outsiders concerning the subject of risk management. In the process of establishing Value at Risk guidelines for banks internationally, the Bank for International Settlement's Basle Accord Guidelines created a standard for maximum risk-taking consistent with conservative banking practice.

The currently established collection of financial accounting statements released by public corporations in capitalist markets is a characterization of historical earnings as summarized by the statements of income, retained earnings and cash flow, along with a statement of assets and claims of ownership as characterized by the balance sheet. The underlying objective of these financial statements has always been to provide outsiders with a transparent way of evaluating the prospective returns to investing in the company's securities. But this approach neglects the second important factor an investor needs to make an intelligent investment decision – a characterization of the company's anticipated risk exposure. Value at Risk is meant to bridge this reporting gap.

This paper compares the market riskiness of the actual banks in the financial markets to the

riskiness of a collection of constructed banks that are constrained to take the maximum risk consistent with the spirit of regulatory constraints on banking risk.

We begin by constructing a collection of regulation-compliant banks. These banks are constructed so that their single period estimated returns are uncorrelated. Together the portfolios span the banks' investment space, thus providing a picture of the performance of all investment alternatives of banks that meet Value at Risk-based risk restrictions formed in the spirit of the Basel Accords.

We form comparisons of these conservative portfolios with the actual risk assumption behavior of financial institutions in our markets. Using our approach, we are able to identify the banking system's choice of investment style – whether the banking system seeks out risky investments or low risk investments, as well as the magnitude of total risks.

Our analysis begins by selecting portfolios from a mutually orthogonal collection of efficient portfolio frontiers of investment returns. Finding efficient portfolio frontiers necessitates the identification of asset return covariance matrices and expected asset returns. Since we are interested in disequilibrium asset returns, we constructed a time series of covariance matrices and expectation vectors that identify the changes in risk and expected return over time in each market, anticipating movement from equilibrium to disequilibrium and back again.

We used data and a GARCH (1,1) process with constant estimates of mean returns derived and explained in detail in Dew (2005a) to model the structure of returns covariances in the three countries.

We used each of the periodic covariance matrix estimates generated by the GARCH models to construct efficient portfolio frontiers.[38] Our efficient portfolio frontiers were constructed from an investment universe consisting of only four of our five original investment choices, leaving out Financials since we were simulating the decision-making process of the financial institutions themselves. We constructed a test for secular equilibrium based on a statistically identified set of portfolio "strategies" ordered by portfolio risk. We construct four orthogonal portfolios ranked by portfolio risk from least to greatest in each time period. We explain this portfolio construction method in more detail elsewhere (Dew, 2005c.)

We further adjust these portfolios, whose weights sum to one, to make their *ex ante* risk consistent with the principles of Value at Risk management. In constructing our hypothetical bank portfolios we place two constraints on bank single period risk-taking. First we constrain the banks' leverage ratios. Our hypothetical banks are not allowed to hold assets worth more than 10 times the size of their capital endowment.

Second, the constructed banks are constrained by a Basle Accord-like Value at Risk (VaR) constraint. VaR analysis is the process of setting the maximum riskiness of the bank, defined as the probability of losing the capital stock over a specified period of time, and letting asset size vary through proportional changes in asset portfolio weights in order to meet the Value at Risk target. In our approach the VaR constraint does not have any effect on relative investment weights within portfolios, which are identified using the weights of the minimum risk risky portfolio on the efficient frontier. We use VaR-induced variance restrictions instead to set a restriction on the asset size of the bank. The effect of VaR in this approach is to reduce the size of all positions in risky periods and portfolios relative to less risky periods and portfolios, balancing assets with liabilities using the reserve account. In effect, the hypothetical banks' capital is fixed and the asset size is reduced until restrictions on the risk of loss are met. The result is a collection of four bank investment portfolio strategies with Value at Risk-constrained exposures over time.

Assuming assets are normally distributed with GARCH variances, we require daily Value at Risk to be equal to the capital stock and to be lost in a 10 day period with probability 0.1%. Since we are using monthly data, the monthly standard deviation divided by $\sqrt{2}$ (assuming independent daily returns with equal variances and 20 days in a business month) is the daily standard deviation and the Value at Risk constraint sets the inverse of the normal probability distribution

$$f^{-1}\left(p = 0.001, \sigma = k \times \frac{\sigma(Assets\ monthly)}{\sqrt{2}}, \mu = 0\right) \geq -0.1,$$

where σ equals the estimated monthly standard deviation of the portfolio, where *p* is the probability on the cumulative distribution function and *k* is the scaling factor that produces Value at Risk of 0.1. Thus there are two constraints. When the leverage ratio constraint is binding, our assumed capital position of 0.1 produces assets equal 1. When the Value at Risk constraint is binding, assets are less than 1 in value. Assets are scaled down while capital is unchanged until the probability of losing the capital stock is at the proper level. Figure 1 provides a graph of the probability distribution when assets are 1 and when they are meeting the binding Value at Risk constraint.

[38] We use a method developed by Huang and Litzenberger (1988) as applied by Jackson (2001).

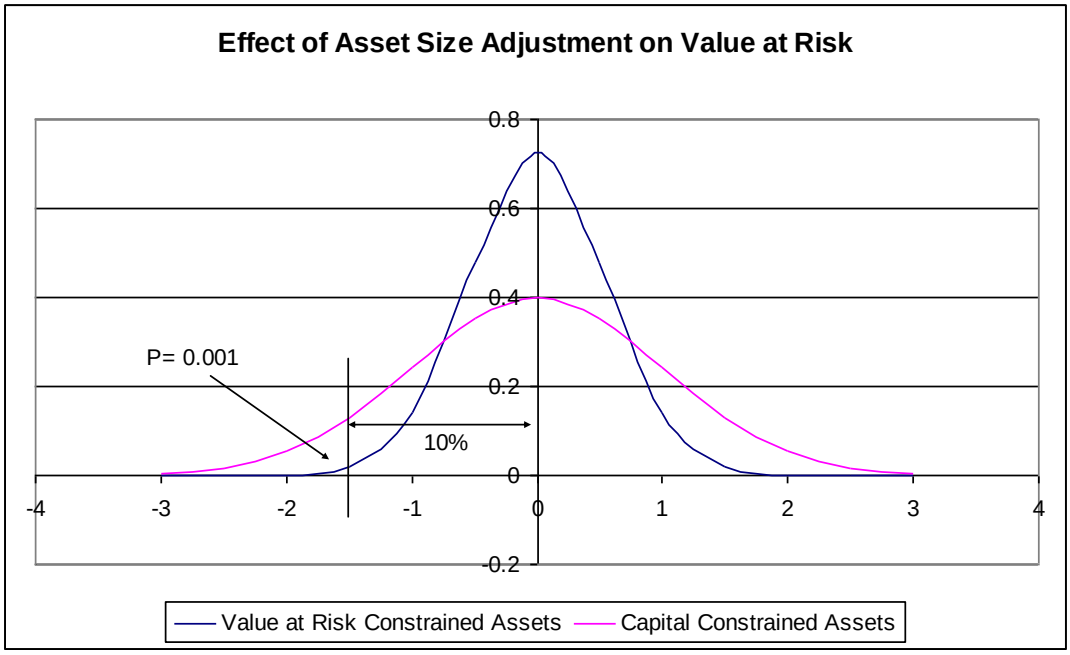

Figure 1. Effect of Asset Size Adestment on Value at Risk

Figure 2 displays the effects of portfolio constraints on asset size in Thailand. As the graph indicates, the leverage constraint was binding before the beginning of the Asian Financial crisis and the Value at Risk constraint binding for the most part thereafter.

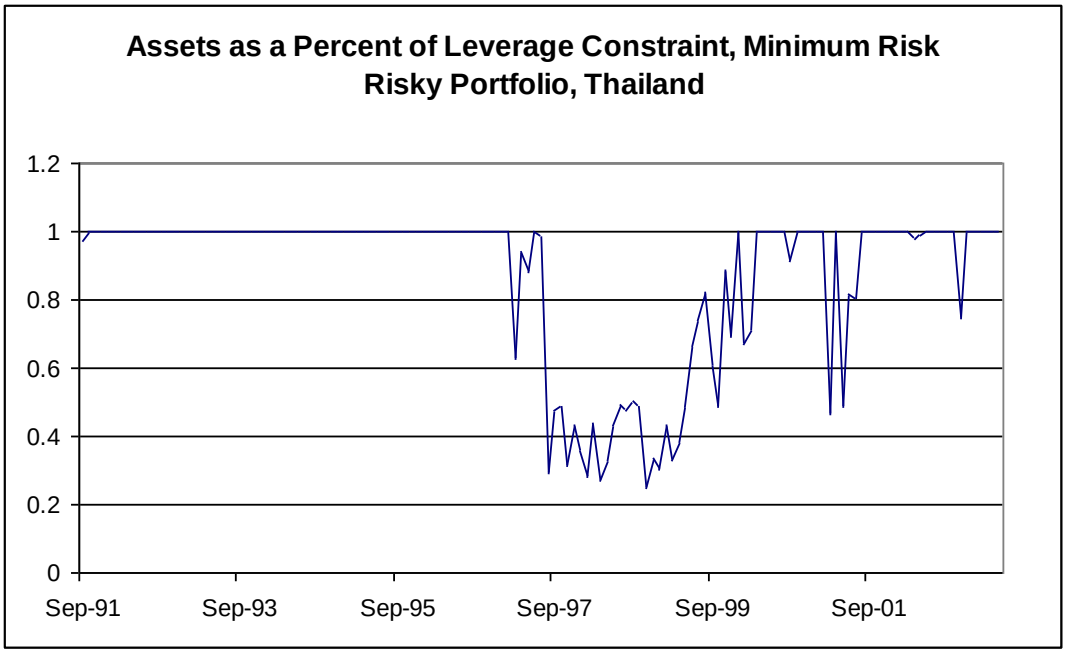

Figure 2. Assets as a Percent of Leverage Constraint, Minimum Risk Risky Portfolio, Thailand

3. Results of Investment Strategies

The resulting set of bank portfolio returns in MT&T is displayed in Figures 3-5 below.

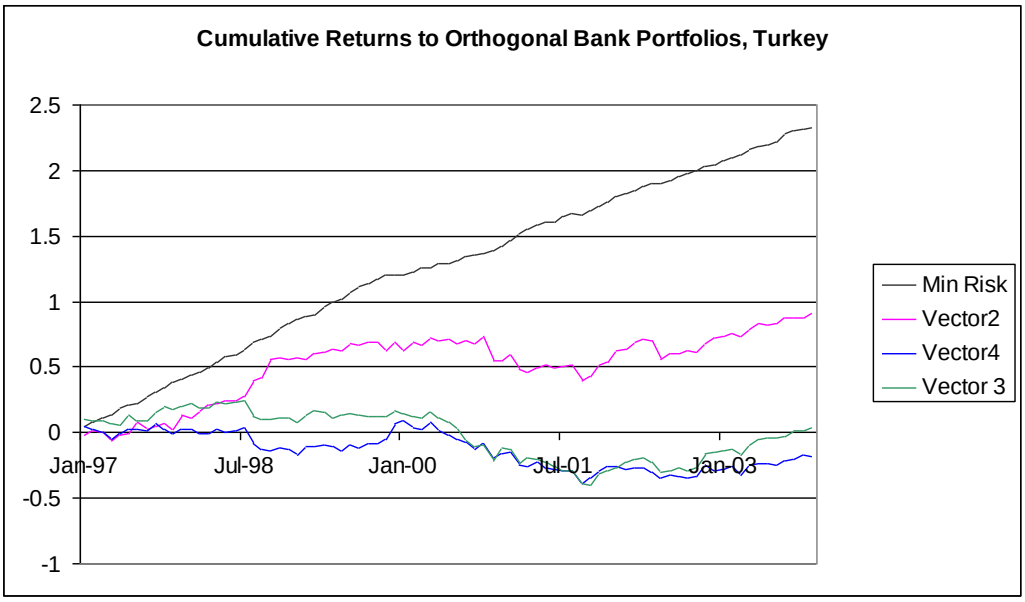

Figure 3. Cumulative Return to Orthogonal Bank Portfolios, Turkey

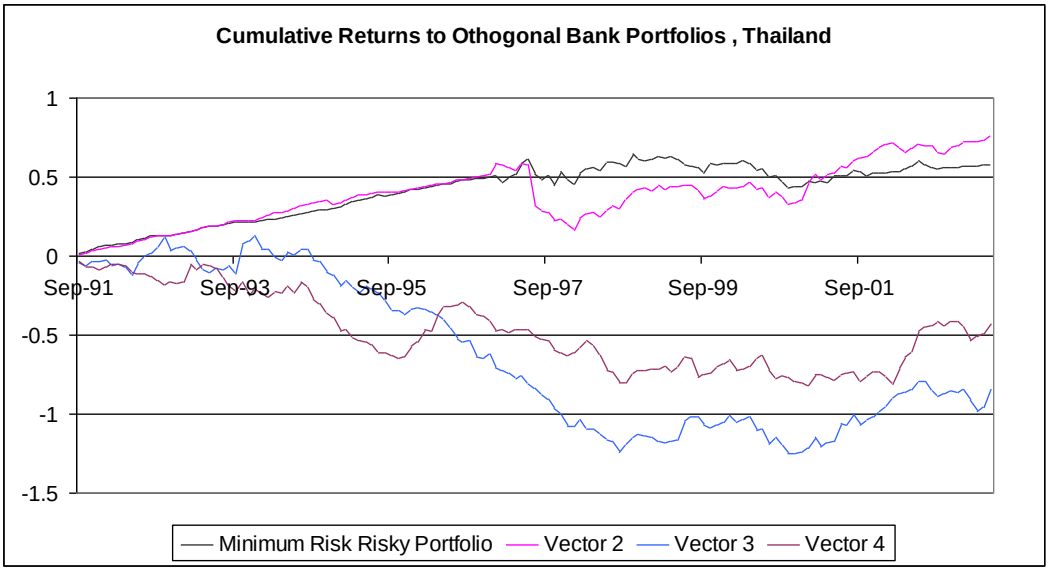

Figure 4. Cumulative Return to Orthogonal Bank Portfolios, Thailand

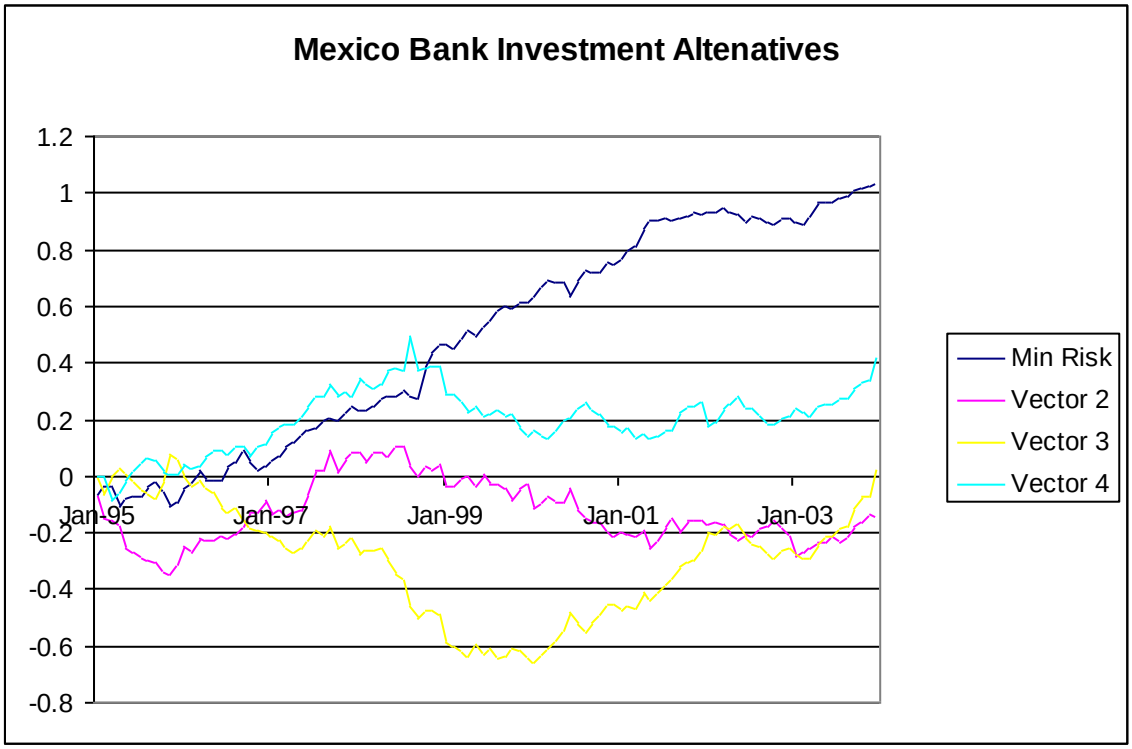

Figure 5. Mexico Bank Investment Alternatives

The four constructed portfolios constrained by bank regulation-like risk rules may be thought of as hypothetical banks, all meeting regulatory capital requirements and differing in investment style. In this way of viewing the portfolios, the equities may be thought of as proxies for more common banking assets such as commercial loans. If bank loans were less risky than the associated corporate equities during the sample periods, but returns to debt and equities closely correlated, our estimates of bank asset sizes under optimal policies will be low, but the estimates of risk/return tradeoffs, the values we use in forming our characterization of bank investment choice, will be close to the correct measures. Note that the lower risk investment styles tend to produce higher investment returns in the three countries. In Dew (2005a) we demonstrate that for investors generally, return is statistically significantly inversely related to portfolio risk for investments with equal position risk in the three countries, an example of market-wide inefficient investment resource allocation.

3.1. How Actual Banks' Performance Compared to the Benchmarks

Using the returns to the four orthogonal bank portfolios, it is possible to decompose the returns to actual banking portfolios to see the market's perception of banking system investment policy. This was accomplished by forming simple linear regressions of the returns to the various orthogonal risk-restrained bank portfolios on the actual financial returns series. The results are displayed in Tables One, Two and Three.

Table 1. Relationship Between Financial Stock Returns and Alternative Portfolio Returns, Thailand

Centered R Squared	0.35976	R Bar Squared	0.340789	
Uncentered R Squared	0.36347	T x R Squared	50.886	
Mean of Dependent Variable	-0.0155			
Std Error of Dependent Variable	0.20332			
Standard Error of Estimate	0.16508			
Sum of Squared Residuals	3.67889			
Regression F(4,135)	18.9646			
Significance Level of F	0			
Durbin-Watson Statistic	1.83569			
Variable	Coeff.	Std Error	T-Stat	Signif.
Constant	-0.003	0.01441	-0.23062	0.81800
Min Risk Portfolio	0.90098	0.77073	1.169	0.24447
Vector 2	-0.2040	0.55631	-0.36674	0.71439
Vector 3	2.38771	0.33563	7.11418	0
Vector 4	0.39828	0.35768	1.11351	0.26747
Sum of Portfolio Weights	3.4828			

These regressions have convenient interpretations. Since the independent variables are orthogonal, multicollinearity is not important. Since the variances of the independent variable series are constant over time, heteroscedasticity of independent variables is not a problem. The high Durbin Watson statistics indicate some negative autocovariance, but coefficient estimates remain unbiased although not efficient under these conditions. Table 2 displays the results of a Box-Jenkins analysis of autoregressive and moving average terms.

Table 2. Box-Jenkins - Estimation by Gauss-Newton, Thailand

Convergence in 16 Iterations. Final criterion was 0.0000043 < 0.0000100				
Dependent Variable FINANCIALS				
Monthly Data From 1991:11 To 2003:05				
Usable Observations	139	Degrees of Freedom	133	
Centered R**2	0.367426	R Bar **2	0.343645	
Uncentered R**2	0.370996	T x R**2	51.568	
Mean of Dependent Variable	-0.01532			
Std Error of Dependent Variable	0.204047			
Standard Error of Estimate	0.16531			
Sum of Squared Residuals	3.634551			
Durbin-Watson Statistic	2.002587			
Q(34-2)	32.92819			
Significance Level of Q	0.421453			
Variable	Coeff	Std Error	T-Stat	Signif
AR{1}	-0.42239	0.532530	-0.79317	0.429092
MA{1}	0.538381	0.499093	1.07872	0.282665
Minimum Risk Portfolio	1.297994	0.777170	1.67016	0.09724
Vector 2	-0.49341	0.558422	-0.88358	0.378515
Vector 3	2.431399	0.329844	7.37135	0
Vector 4	0.267356	0.369408	0.72374	0.470496
Sum of Portfolio Weights	3.503335			

Box-Jenkins estimates of various ARMA structures yield no significant influence of past values of the dependent variable, but eliminating what autocorrelation was there tended to increase the magnitude of portfolio weights marginally. Table 2 displays the most successful adjustment for dependence on past values of the dependent variable for Thailand, which was representative of results in the other two emerging markets.

Table 3. Relationship Between Financial Stock Returns and Alternative Portfolio Returns, Turkey

Dependent Variable FINANCIALS				
Monthly Data From 1997:02 To 2003:11				
Usable Observations	82	Degrees of Freedom	77	
Centered R**2	0.81126	R Bar **2	0.801453	
Uncentered R**2	0.81126	T x R**2	66.523	
Mean of Dependent Variable	-0.0003			
Std Error of Dependent Variable	0.20212			
Standard Error of Estimate	0.09006			
Sum of Squared Residuals	0.62457			
Regression F(4,77)	82.7409			
Significance Level of F	0			
Durbin-Watson Statistic	1.80373			
Variable	Coeff.	Std Error	T-Stat	Signif.
Constant	-0.0093	0.021613	-0.42964	0.66866
Minimum Risk Portfolio	0.69583	0.699091	0.99534	0.32269
Vector 2	0.14200	0.218619	0.64952	0.51794
Vector 3	0.09514	0.369003	0.25784	0.79722
Vector 4	4.21012	0.397045	10.60361	0
Sum of Portfolio Weights	5.1409			

All three countries show significant coefficients for at least one of the second, third or fourth vectors, the coefficients exceed one in at least one case in each country, and sum to something exceeding three in every country.

Table 4. Relationship Between Financial Stock Returns and Alternative Portfolio Returns, Mexico

Dependent Variable FINANCIALS				
Monthly Data From 1995:01 To 2003:12				
Usable Observations	108	Degrees of Freedom	103	
Centered R**2	0.33249	R Bar **2	0.306571	
Uncentered R**2	0.33251	T x R**2	35.911	
Mean of Dependent Variable	0.00056			
Std Error of Dependent Variable	0.11932			
Standard Error of Estimate	0.09936			
Sum of Squared Residuals	1.0169			
Regression F(4,103)	12.826			
Significance Level of F	0.0000			
Durbin-Watson Statistic	1.8336			
Variable	Coeff.	Std Error	T-Stat	Signif.
Constant	-0.0032	0.010271	-0.32086	0.74897
Minimum Risk	0.82523	0.371451	2.22164	0.02850
Vector 2	1.39164	0.283508	4.90865	0.00000
Vector 3	0.68354	0.279491	2.44567	0.01615
Vector 4	0.59465	0.291113	2.0427	0.04364
Sum of Coefficients	3.49507			

The Mexico results are similar to those of Turkey and Thailand. The sum of the weights of the four significant return vectors is about 3.5 suggesting, as with the financial systems of Turkey and Thailand, more risk is being taken than regulators have mandated. The significant coefficient of the Minimum Risk vector in Mexico suggests that Mexican bank portfolios are carrying more government debt than are the banks of Thailand and Turkey. In addition, Mexican financial institutions appear to be spreading their risks among factors to a greater degree than the other two country financial sectors.

The regressions on the whole tell similar stories about investment style as well as investment magnitudes. Coefficients of portfolios found in our earlier studies to be relatively low risk, high return portfolios are not important. In fact they are insignificant in Thailand and Turkey. Returns to portfolios of high risk, low return investments dominate results.

The regression results for the post crisis periods in the Turkey and Thailand give us no reason to expect that the banking systems of the two countries will reduce their destabilizing effects in the future. In Thailand particularly, there is a major increase in risk magnitudes in the post crisis sub-sample as displayed in Table 5 below.

Table 5. Relationship Between Financial Stock Returns and Constructed Portfolio Returns Following the Crisis, Thailand

Dependent Variable FINANCIALS				
Monthly Data From 1997:09 To 2003:05				
Usable Observations	69	Degs. of Freedom	64	
Centered R**2	0.423935	R Bar **2	0.387931	
Uncentered R**2	0.425593	T x R**2	29.366	
Mean of Dependent Variable	-0.01277			
Std Error of Dependent Variable	0.23955			
Standard Error of Estimate	0.18741			
Sum of Squared Residuals	2.24801			
Regression F(4,64)	11.7746			
Significance Level of F	0.0000			
Durbin-Watson Statistic	1.590431			
Variable	Coeff	Std Error	T-Stat	Signif.
Constant	-0.03166	0.02353	-1.3453	0.18328
Min Risk	0.29456	0.99567	0.29583	0.76831
Vector 2	2.28815	1.04757	2.18425	0.03261
Vector 3	1.64873	0.65618	2.51262	0.01451
Vector 4	0.90651	0.56944	1.59192	0.11632
Sum of Coefficients	5.138			

In Turkey, similar increases in the size of coefficients indicate similar increases in bank riskiness after the crisis.

Table 6. Relationship Between Financial Stock Returns and Constructed Portfolio Returns Following the Crisis, Turkey

Dependent Variable FINANCIALS				
Monthly Data From 2000:12 To 2003:11				
Usable Observations	36	Degs. of Freedom	31	
Centered R**2	0.859845	R Bar **2	0.84176	
Uncentered R**2	0.85999	T x R**2	30.96	
Mean of Dependent Variable	-0.00697			
Std Error of Dependent Variable	0.219057			
Standard Error of Estimate	0.08714			
Sum of Squared Residuals	0.235393			
Regression F(4,31)	47.5458			
Significance Level of F	0			
Durbin-Watson Statistic	2.130817			
Variable	Coeff	Std Error	T-Stat	Signif.
Constant	-0.0086	0.03130	-0.2747	0.7854
Minimum Risk	-0.08057	1.08447	-0.0743	0.9413
Vector 2	0.75308	0.46192	1.63029	0.1131
Vector 3	-0.96568	0.54824	-1.7614	0.0880
Vector 4	5.43507	0.66774	8.13942	0
Sum of Coefficients	5.1418			

Total factor loadings of the risky factors have increased and the weight of the higher risk factors have grown relative to the full sample relationships. The banks in the two countries have apparently not reacted to the increased riskiness of their financial systems by trimming their exposure.

In Germany regression results lead to somewhat different conclusions.

Table 7. Relationship Between Financial Stock Returns and Constructed Portfolio Returns, Germany

Multiple R	0.593406				
R Square	0.352131				
Adjusted R Square	0.334034				
Standard Error	0.055934				
Observations	185				
ANOVA					
	df	SS	MS	F	Signif
Regression	5	0.304389	0.060878	19.45807	0.0000
Residual	179	0.5600315	0.003129		
Total	184	0.8644207			
	Coeff.	Standard Error	t Stat	Signif.	
Constant	-0.00592	0.004299	-1.37731	0.170137	
Minimum Risk	0.908271	0.137041	6.627731	0	
Vector 2	0.504512	0.141835	3.557046	0.000480	
Vector 3	0.664102	0.134013	4.955493	0	
Vector 4	-0.22691	0.153638	-1.47694	0.141450	
Sum	1.845031				

The performance of German financial institutions relative to benchmarks indicates that German institutions are considerably less exposed to the magnitude of risk than their emerging market counterparts but still bear substantially more total risk than the benchmark bank portfolios. Interestingly exposure is spread more broadly across vectors. Furthermore exposure was mainly to less risky investments in the first three vectors suggesting a more conservative investment style as well as less total risk.

Conclusions

We introduce a procedure for testing market perception of the risk exposure of banks. We examine the riskiness of banks in three emerging markets – Mexico, Turkey and Thailand, and find that the average financial institution is between three and six times as risky as a bank meeting our constructed Basel Accord-motivated risk controls would be. We examine whether the greater risks being taken by these banks could be justified by stockholder demands for greater return. Our evidence suggests that the banks had alternatives that were much less risky with much higher expected returns. These results are consistent with the proposition that bank asset allocation decisions in the three countries were insensitive to both the restrictions of bank regulation out of concern for the safety of deposits and the concerns of bank stockholders for the risk and return properties of bank stocks. The banks appear to allocate their resources according to other management concerns.

The same conclusions do not hold in the case of market perception of German financial institution risks. The evidence suggests that markets perceive banks to be taking less total risk and to be choosing investments which contribute less to the banks' risks than market alternatives.

This is substantial evidence that an important source of the market inefficiencies identified in our earlier work is agency problems within the banking systems of the three emerging markets countries. The banks pursued disastrous policies of lending to closely held affiliates and related entities amid accusations of gross mismanagement and self-dealing. This reality on the ground was cloaked in a fog of legal reform, regulatory reform, privatization promises, IMF commitments and other government public relations initiatives

The governments of Mexico, Thailand and Turkey seek to promote foreign participation in their nascent financial markets and to gain the approval of foreign official institutions providing economic subsidies by passing legislation liberalizing financial markets favored by these investors and institutions. However, governmental

enthusiasm for implementation of liberalizing regulations controlling the behavior of self-seeking corporate managers of closely held banks lending to their affiliates and to related entities, amid considerable apparent self-dealing, has been kept well under control.

Banks could have operated at a profit in these three countries during the past fifteen years, including during financial crises when most banks became insolvent in both Turkey and Thailand, had they put the interest of stockholders first. However, instead they pursued riskier than desirable strategies with lower anticipated – and in the outcome much lower actual – returns. This apparent disparity between management's plans and interests of depositors and stockholders dramatizes the difference between the liberal financial system the countries would have us believe they are and the control economies that they may really be. The continuous process of reform in these countries and regular and enthusiastic adoption of international standards of bank regulation, but with no associated change in market perception of the riskiness of the banks, tells us that according to investors the song has changed, but the singer is the same.

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