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Bank portfolio exposure to emerging markets and its effects on bank market value

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Abstract

This study estimates a model of banking company equity returns taking into consideration book value and market value measures of their exposure to emerging markets debt. In this estimation, general systematic market factors, such as the rate of return on the S&P500 stock index and yields on a constant maturity 5-year Treasury note, are held constant such that the exposure variables are accounting for effects due to banks' exposure to emerging market debt. The results, although not uniform among banking companies, support the hypothesis that the extent of exposure to emerging market debt are factored into the valuation of banking company equity contemporaneously. The inclusion of a market value indicator adds to the explanation of equity returns of some banks. It is also clear that knowing the extent of the exposure on a book value basis is important information alone that may allow investors to take account of or evaluate the effects of changes in banking company equity valuation from LDC debt exposures. We also perform an event study for three major debt crises to determine whether the market recognizes the effects of these events on bank valuation. The event study results show that there is little information from identifying the time period of the crises on banking

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company equity returns. Explanations for this are that the information of these possible crises has been embedded in bank changes in exposure and that the market valuation of the emerging market debt is already accounted for by our model.

JEL classification: G12; G14; G15

Keywords: Emerging market crises; Bank value; Debt information

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1. Introduction

Large US banks have been heavily exposed to debt from emerging countries. As these countries have encountered serious financial problems, the value of emerging country debt has decreased, with a potential negative impact upon banks. This paper addresses the issue of whether the market, through the equity price of the banks, fully values these debt valuation changes. Crucial to the analysis is whether the information about individual country debt holdings of large US banks is sufficiently transparent so that it can be recognized by investors. Market participants may only be aware of the total foreign debt exposure of the banks, but not the exposure from individual countries. The extent of general knowledge about country exposure will affect the degree to which changes in the value of country debt is reflected in the value of bank equity. This paper examines whether country debt valuation is reflected in bank stock prices overall and during the periods of financial crises.

The devaluation by Mexico of the peso on December 20, 1994, the rapid depreciation of the Thai baht and Indonesian rupiah in the Fall of 1997, and the Russian ruble devaluation by over 60 percent in 2 weeks in August 1998, followed by massive infusions of capital by the IMF to avert an international monetary crisis, serve as a reminder of the financial and political instability of many of the lesser developed countries and emerging markets. As a consequence, lenders and investors to Mexico, Russia. Indonesia, the Philippines, or other emerging nations, must rely upon the timeliness and willingness of international organizations, central bankers of major industrialized countries, and the world's bankers to provide funding to avert crises and support investor value – bank or nonbank.

The experience of the less developed country (LDC) debt crises of the 1980s provides substantial evidence that few, if any, long term solutions are viable. The swap of bank loans for security debt under the Brady plan – so-called Brady bonds – is a solution applied to a special case. During the period beginning with the 1982 Mexican default to about 1990 with the institution of the Brady Plan, US banks with large exposures reserved for large LDC losses, showed poor profitability relative to others in the industry, and were the subject of intense supervisory scrutiny and capital adequacy forbearance by bank supervisors. Based on this experience, US and global banks may be unwilling to accept large emerging markets risk exposures again without substantial guarantees beforehand. With the extensive growth of capital markets in many nations, the vehicle for investment has expanded as have the risks arising