

Comments on “Financial globalisation, governance, and the evolution of the Home Bias”

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What the Paper Does and Does Not Do

- **What it does:**

- **Provides an innovative approach to explaining the still unresolved “puzzle” of the HB in global asset portfolios**
- **Proposes as explanation for the HB an interesting combination of the Portfolio Model and the Corporate Finance theory of Optimal Insider Ownership**
- **Adds a new interpretation to the existence HB in equity markets highlighting the role of governance and institutions, and the relationship between these and corporate ownership concentration.**

- **What it does not:**

- **Adress HB in bond markets, where it also prevails and is even higher than for equities**

The optimal insider ownership theory of equity HB

The hypothesis to be tested

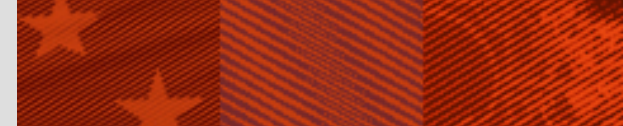


Two competing forces linking HB to optimal insider ownership:

- **A direct channel from insider ownership to foreign holdings : availability of shares**
- **An incentive-driven channel**

The optimal insider ownership theory of equity HB

The evidence using holdings of US investors

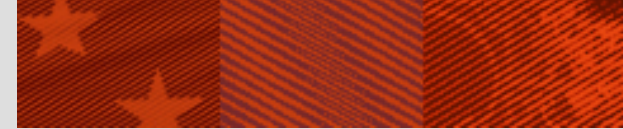


- **Evidence supports the first channel (availability)**
 - **HB decreases when the fraction of market's capitalization available to foreign investors increases**

 - **Evidence does not support the second channel (incentives)**
 - **Using the float-adjusted portfolios, governance and institutions not significant in accounting for the HB.**
- ⇒ **Governance and institutions matter for HB but only through the first channel.**

The optimal insider ownership theory of equity HB

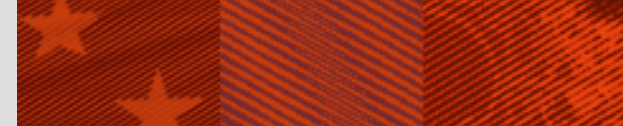
The evidence in the Korean case



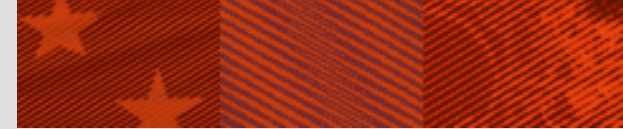
- **Evidence supports the first channel (availability)**
 - **Foreign ownership of Korean firms increase when the fraction of market's capitalization available to foreign investors increases.**
- **But evidence also supports direct role of governance in HB (over and above its impact on insider ownership).**

The optimal insider ownership theory of equity HB

Comments on the results



- Interesting that (national) governance does not directly influence HB in US investors case but (corporate) governance does influence HB in the Korean case ⇒ to be explored further
- Can foreigners also play an insider role (as third related party)?
- It would be interesting not just look at US data but also to other countries (cross sectional analysis for a given year) to see if the “US-investor based” evidence is confirmed or, if there are differences, why is so.
- It would be interesting to run a 2-equation rather than a 1-equation model:
 - (1) $HB = f(\text{insider ownership, others})$
 - (2) $\text{insider ownership} = g(\text{institutional and governance variables})$
- Important role of local financial markets development (liquidity).



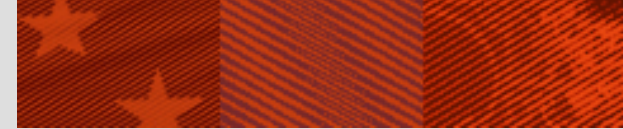
- **Is there value in looking at different regional groupings?**

- **How about HB in bond markets?**

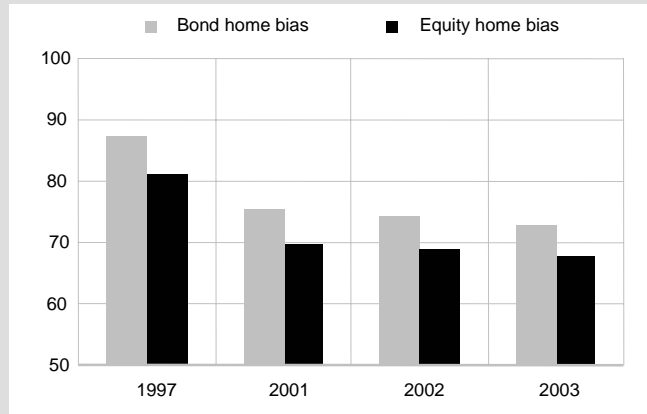
⇒ **The case of the euro area: changes in HB in equity and bond markets**

Bond and Equity HB (CPIS)

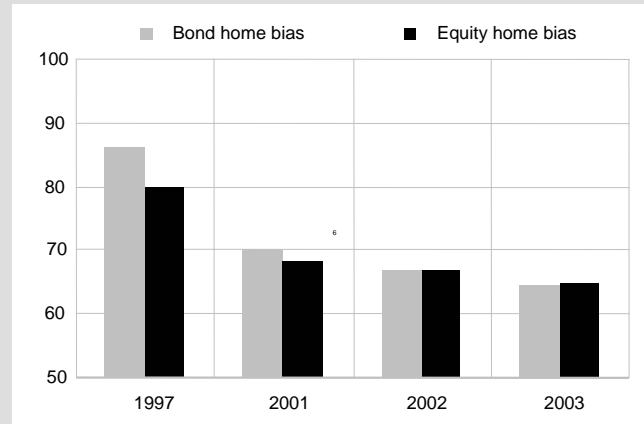
HB declining, albeit unevenly across areas and asset-classes



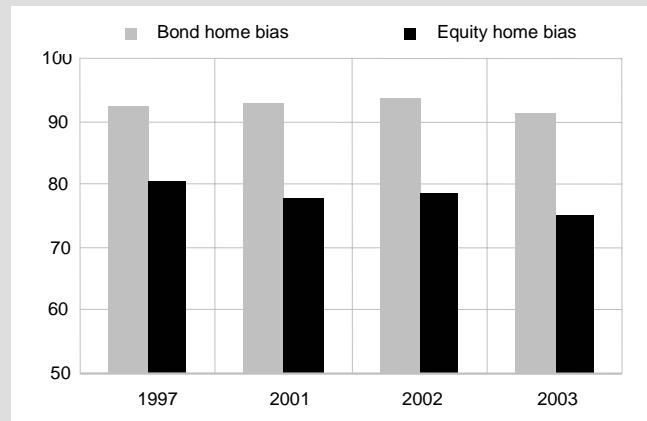
Mature economies



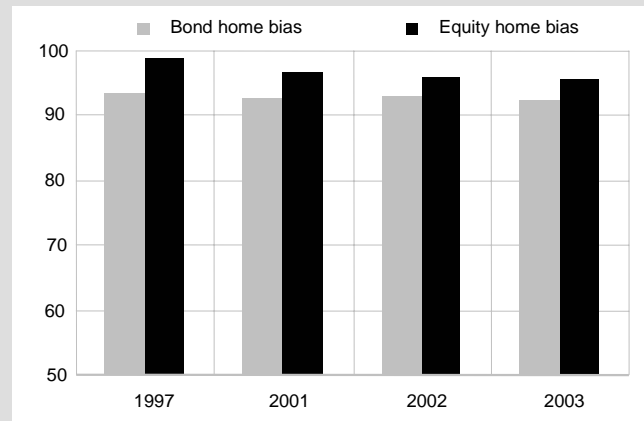
Euro area economies



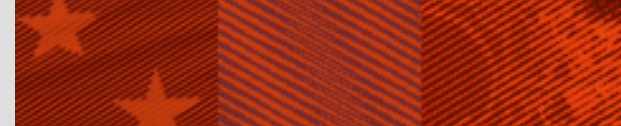
United States



Emerging economies

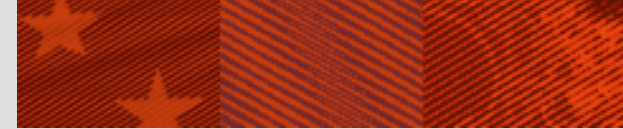


Source: ECB based on IMF CPIS.

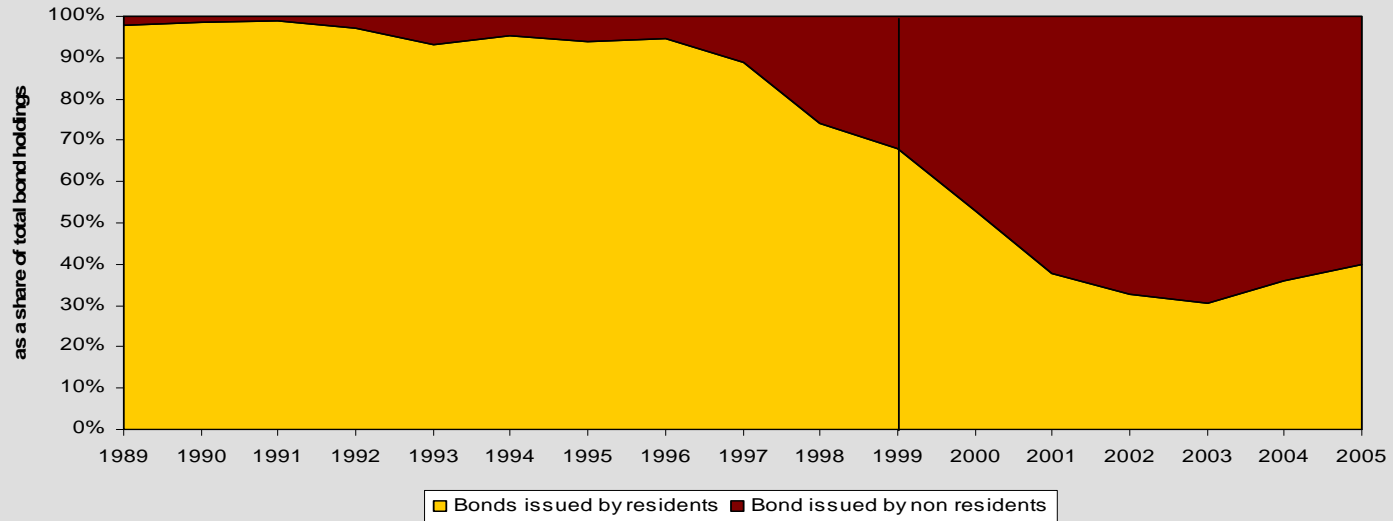


- **HB is still rather high (>60%) worldwide, particularly in emerging markets.**
- **However, HB has declined much more among mature economies than emerging markets.**
- **Within mature economies, HB has fallen substantially in the euro area and not as much in the US, where HB has remained rather stable especially in bonds.**
- **In the euro area, it is HB in bonds that has dropped more prominently.**

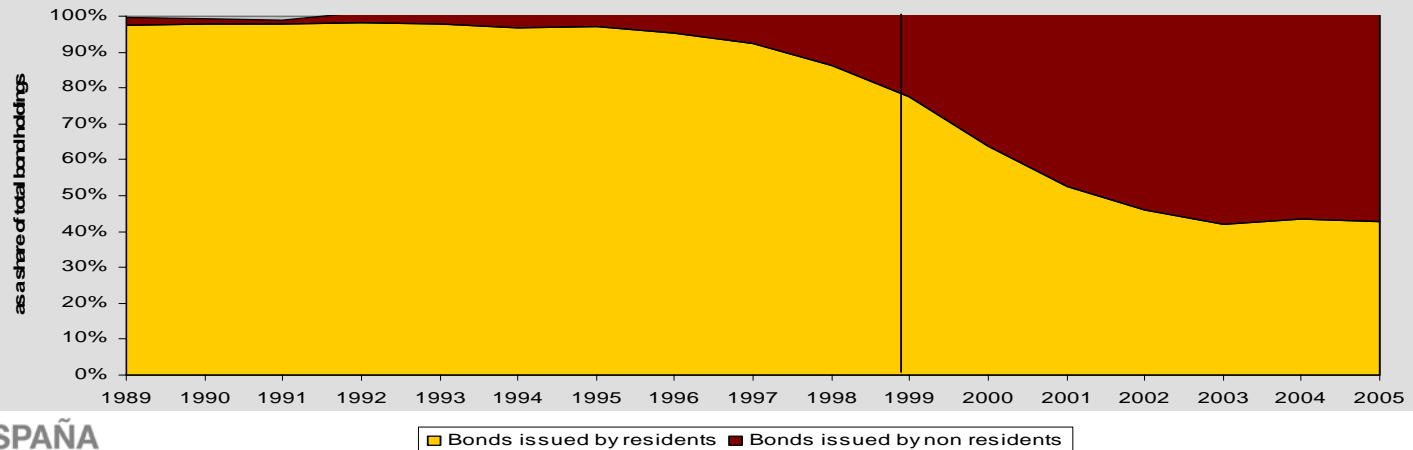
Another way to look at HB: the internationalization of portfolios of institutional investors



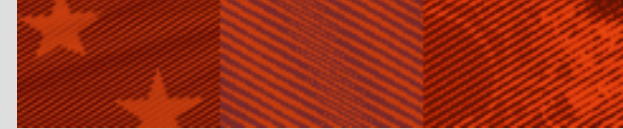
Bond Holdings by Spanish Investment Funds



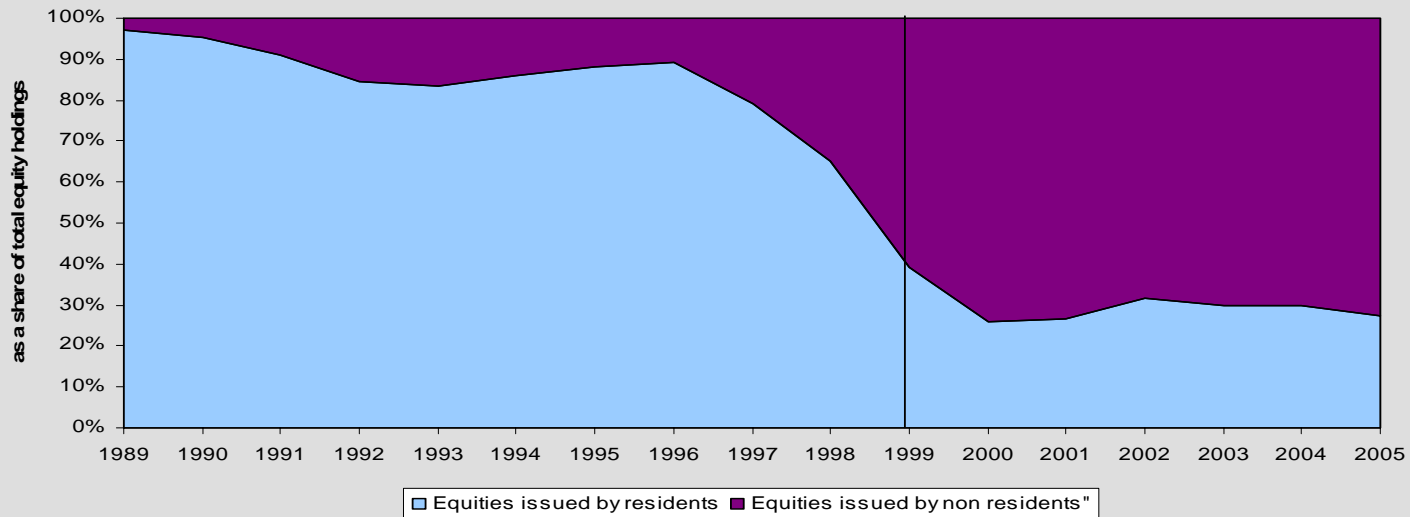
Bond Holdings by Spanish Pension Funds and Insurance Companies



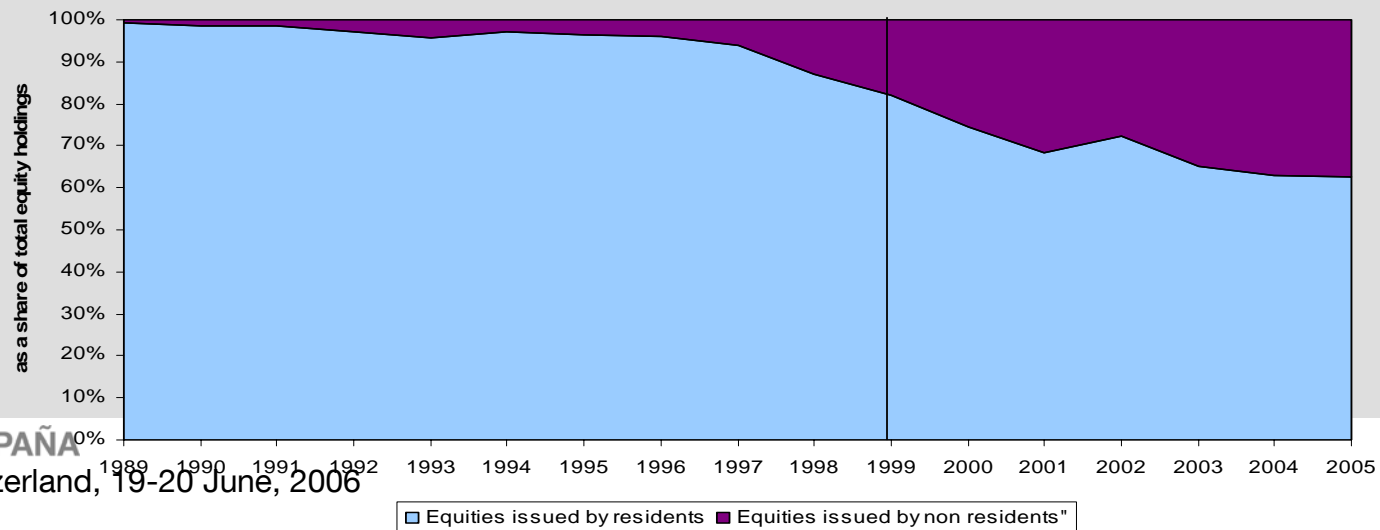
Another way to look at HB: the internationalization of portfolios of institutional investors



Equity Holdings by Spanish Investment Funds



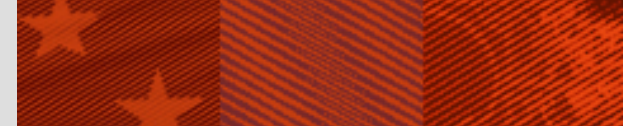
Equity Holdings by Spanish Pension Funds and Insurance Companies



HB in bond markets

- **Two types: government bonds and corporate bonds**
- **Government bonds**
 - **Ownership concentration not relevant for explaining HB**
 - **Strong evidence that macro policies, institutions and governance do matter for HB**
- **Corporate bonds**
 - **Ownership concentration not relevant directly since no “availability” effects**
 - **Still, ownership concentration could be relevant in so far as it relates to the extraction of private benefits by the insider and thus might affect the firm’s credit standings ⇒ role of institutions and governance**
- **Unfortunate, CPIS does not allow separately testing for government and corporate bonds HBs**

Explanations for the reduction in HB, primarily in Europe (bonds and equities).



- Euro area is the group of countries where insider ownership has fallen the most
- Alternative explanations to K-S-W- based on portfolio theory+other elements (macro, institutional)
- According to De Santis and Gerard (2006)
 - EMU and, in particular, its institutional framework, is main determinant of reduction in HB, having eased the access primarily to bond markets, and also to equity markets.
 - Result: greater regional financial integration in the euro area
 - Powerful role of institutions
- According to Lane (2005)
 - Regional financial integration is leading financial globalization.
 - Euro area bias in bond markets: euro area countries invest disproportionately in one another relative to other country pairs.
 - Positive connection between trade linkages and financial linkages
 - Powerful role of institutions
- Fidora, Fratzscher and Thimann (2006)
 - Real exchange rate volatility is a key driver of portfolio HB at the global level for both bonds and equities.
 - A reduction in volatility sharply reduces HB in equities, and even more in bonds.
 - Role for macro policies.

Policy Implications

- In general, so long as correlations among different asset classes and domestic and foreign assets remain imperfect, there are gains to be made from international portfolio diversification, and therefore, from a reduction in HB
- Lower HB also means better risk sharing across countries and in this way it should enhance global financial stability
- The paper rightly highlights the importance of improved institutions and improved governance for financial integration
- What else can be done to reduce HB?
 - Improve financial markets infrastructure (legal, operational)
 - Improve market discipline through the development of
 - *diverse investor base (for instance through institutional investors)*
 - *Increase transparency and disclosure*
- Macro policies
- Better institutions and financial integration reinforce each other and help promote economic growth