The effects of foreign banks entry in emerging market economies

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Abstract

This paper investigates the effects of foreign bank entry in emerging mar-kets. We developed a picture of a multinational bank in an emerging markets by combining statistics from several sources, in order to explore broad range of effects that brings foreign bank entry in the developing countries. Some im-pacts of foreign bank entry have been thoroughly studied, while others are hardly mention. Entry of foreign bank brings large benefits to host country's financial system and economies at large. This paper is studing those benefits very carefully, by analyzing the impact of foreign bank entry on economy, go-vernment, monetary policy, large enterprises, small and medium size enterpri-ses, domestic bank etc. But, we also considere the fact that at the same time, foreign investment in the finacial sector, rises some concerns, and therefore we analyze the negative effects as well. At the end we must admit that although there are some negative consequences from foreign bank entry in emerging markets, the benefits that arise from foreign banks penetration are much more, and this trend of foreign bank entry has brought new positive economic impuls in developing world.

Key words*: Foreign bank entry, emerging markets, benefits, negatives*

Introduction

Between 1920s and 1980s several countries had allowed fore-ign bank entry in their economy. Since that time the situation has changed dramatically. After the financial and currency crisis in 1990s many emerging market economies in particular in Latin America and Eastern and Central Europe, has opened up their banking system for foreign banks entry. As a result of liberaliza-tion financial markets have become increasingly integrated, and many multinational banks have expanded their presence signifi-cantly in many emerging market economies. Although global ban-ks mainly improve the efficiency, stability and competition in the banking sector, such entry may have some harmfull side effects. Some impacts of foreign banks entry have been thoroughly stu-died, while other are seldom mentioned. Foreign banks entry is especially important for the policymakers in emerging market economies who are mainly concerned with the reason, the back-ground of foreign bank participation in EMEs. The aim of this pa-per is to highlight some policy – oriented issues, that have arisen with the massive entry from multinational banks, from the host country perspective.

The aim of this paper is to also give answer on some questions, that still are being debated and to summaries the current know-ledge on these issues. What draws foreign bank to a country? Why banks go abroad? Where banks go abroad? What are the biggest benefits from the foreign banks entry for the emerging market economies? What are the potential negatives?

1. How banks go multinational

Multinational banks (MNB) by definition, are those that physically operate in more than one country. MNB should be differed from international banks, which engage in cross-border operations and do not set up operations in other countries. There are mainly two forms by which foreign banks set up its operations in emerging market economies - through cross-border mergers and acquisitions or via Greenfield investment.

Investment through mergers and acquisitions is also knows as investment through taking over. What this means is that foreign bank buy existing banks in the emerging market economy. Initially, foreign bank buys a small part of a domestic bank and over time expand their investment, until the majority ownership is acquired. This approach may be regarded as typical for expansion into the transition countries, where the privatization on state owned banks, has taken place. In some countries, buying an existing bank means getting around restrictions concerning greenfields. For instance, in most cases in Poland foreign banks were required, in order to take over existing troubled Polish banks, and obtain licenses (EBRD, 1998).

Foreign banks entry can be made many in a different ways. The entry determines the type of operation and level of risk that the foreign bank will bear.

Foreign banks can adopt a range of organization forms when entering host countries.

- ***Representative office*** – the most limited, but most easily established organization form. This setup does not accept deposits, nor does it make loans, they act as a agents for foreign banks, and generally established to test the possibility of further invest.

- ***Agencies***- more expensive form of entry. They can make commercial and insustrial loans but can not make consumer loans or accept deposit.
- ***Branches*** – most important organization form. Is an integral part of a parent bank, whit the ability to draw on the parent's capital base and offer a wide range of services.
- ***Subsidiaries*** – permitted to engage in a broader range of financial services. In many countries they have powers identical to those of domestic banks and thus regulated the same way.

2.Potential benefits from foreign market entry in emergin market economies

The entry of foreign banks brings large benefits to host countries' financial system and economies at large. Benefits can different, from efficiency gains brought about by new technologies, products and management techniques as well as from increased competition stimulated by new entrants. Foreign banks also have greater access to resources from abroad, they have more stable funding and lending pattern than domestic banks. Another benefit comes whit the fact that they hold a more geographically diversified credit portfolio and consequently would not be as affected during periods of stress in the host country. In EME[1] where wealth is highly concentrated it is common that bank's board members, stockholders and large borrowers are closely related. Foreign banks do not get involved in connected lending, both because they do not have related parties in the host country and their widely held equity structure does not encourage this kind of behavior. Foreign banks can have stabilizing role during the crisis in the host country, because they will bring new and fresh capital whenever EMEs countries suffer from financial or real sector crisis.

As we can see from the previous part, benefits for the host countries from the foreign banks entry can be large and different. Now, we will try to summarize them.

2.1. Improving the efficiency and profitability

Although there are differences between the studies that examine the impact of foreign banks entry on the efficiency and profitability in host countries' banking sector, generally accepted fact is that foreign bank entry, increases efficiency and profitability in domestic banking system. The reason is that foreign banks have superior credit technologies, better management, expertise and governance structures and are less open to government and political interference than domestic banks.

First off, we have to differentiate the impact of foreign banks entry in EMEs and the impact in developed countries, simply because the results are different.

[1] EME – Emerging market economy

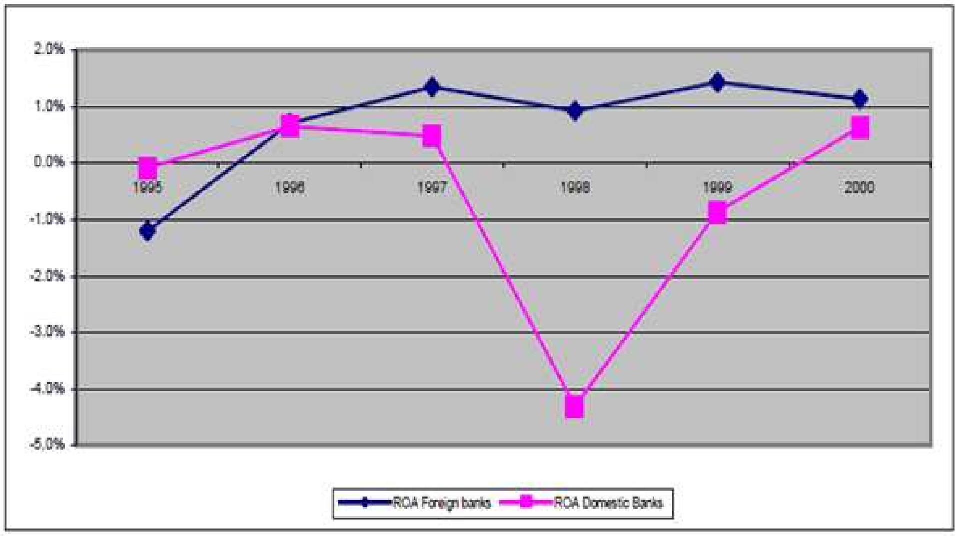
Mainly, what is true for EMEs does not apply for developed countries. Foreign banks are more profitable and efficient than domestic banks in EMEs , while in developed countries domestic banks are more profitable and efficient than foreign banks. These differences can reflect a differential impact on informational advantages, customer base, bank procedures as well as different relevant regulatory and tax regimes.

There are only few studies on the profitability and efficiency of the banking sector in the EMEs. Green et al. (2002) estimate the efficiency of domestic and foreign banks in CEE countries, in terms of economies of scale and scope. They find that foreign banks are not really different from domestic banks and that bank ownership is not an important factor in reducing bank cost. Yildirim and Philippatos (2002) find that foreign banks in transition countries are more cost efficient, but less profit efficient relative to domestic banks. Zajc (2002) found for six European transition economies, that foreign bank entry reduces net-interest income and profit, and increases cost of domestic banks.

In order to examine to what extent foreign banks are more efficient and profitable in transition countries, Naaborg et al. investigate a number of indicators at aggregate level for both foreign and domestic banks: the return on assets (ROA), after tax income and overhead costs. The first indicators reflects banks' profitability and final one reflects operational efficiency of the banks.

Fifure 3 gives the average ROA for foreign and domestic banks. It appears that the average ROA of foreign baks is higher, then the average ROA of the domestic banks.

Figure 3. Return on assets (ROA) of banks in CEE countries: foreign vs domestic banks, 1995-2000

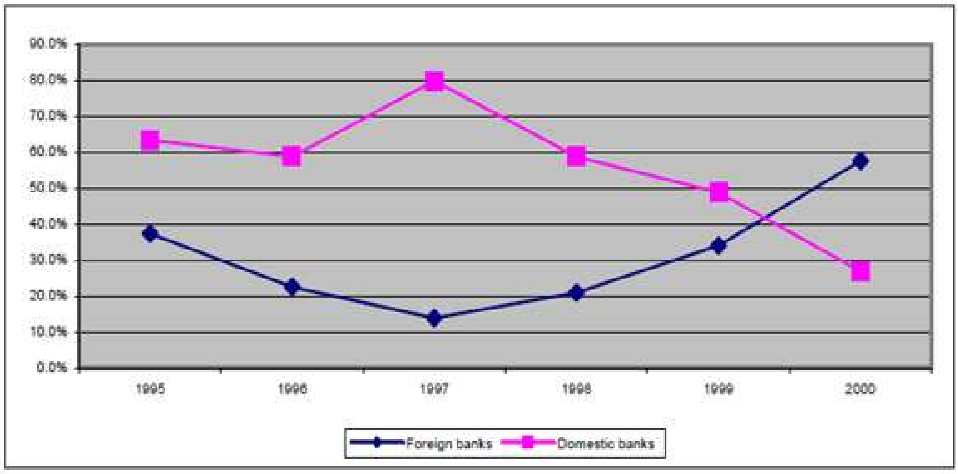


Source: Central banks of Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Romania, the Slovak Republic and Slovenia.

Figure 3 shows that the ROA of domestic banks, tends to converge to the average ROA level of foreign banks. The general conclusion can be that both for domestic and for the foreign banks there is an upward trend in ROA, while domestic banks were more sensitive to the economic and financial crisis in 1998 (moratorium from the Russian debt crisis) than foreign banks.

What applies to after tax income we can see from figure 4.

Figure 4. After-tax income of banks in CEE countries: foreign vs domestic banks, 1995-2000

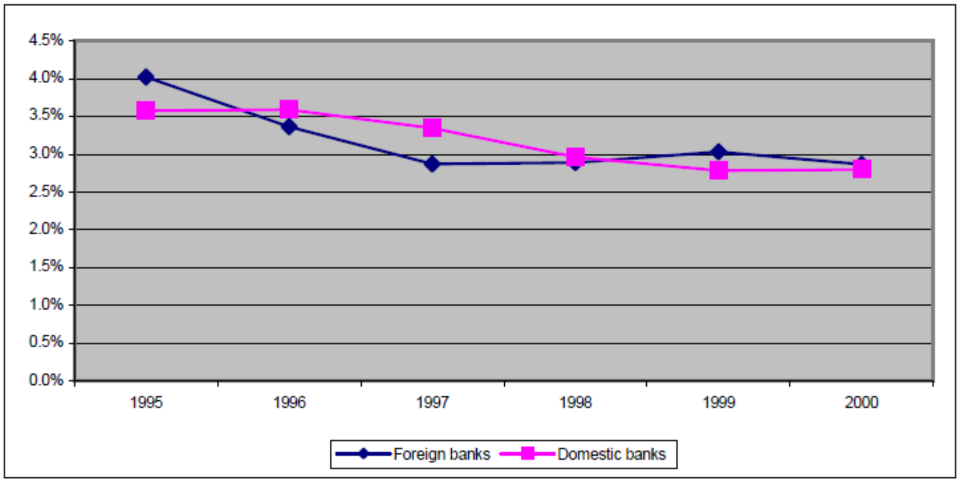


Source: Central banks of Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Poland, the Slovak Republic, Slovenia.

As shown in the Figure 4 domestic and foreign banks are subject to contrasting developments in their after-tax income. As foreign banks initially experienced a decreasing after tax-income, after 1997, their tax income followed an upward trend. Domestic banks however generate lower income every year since 1997.

Now we are going determine non-interest cost in CEE countries. Figure 5 shows that the costs of foreign banks are lower than those of domestic banks.

Figure 5 Average non-interest costs of banks in CEE countries: domestic vs foreign banks, 1995-2000



Source: Central banks of Croatia, the Czech Republic, Estonia, Hungary, Lithuania, the Slovak Republic, Slovenia.

Figure 5 reveals that the differences between domestic and foreign banks in the overhead costs, as percentage of the total assets are rather small. In addition, one can observe that downward trend for both domestic and foreign banks, which is a proof that foreign banks entry can improve efficiency in the whole banking sector.

In summary, we find that foreign banks in the transition economies, generally outperform domestic banks in terms of bank profitability.

2.2. *Improving competition in the host country*

This benefit is closely associated with the previous. Namely, improved competition brings better efficiency. As the number of market participants increases, so will the fight between them for customers. They will have to offer more sophisticated and cheaper banking services. This is especially for domestic banks, that will not survive ,if they do not offer better services. As a result of more competition on the financial market, the banks may also foster development of new financial products, through imported technologies and know-how. An example of this, are derivatives products, that now are playing very important role in many countries. Face with the competition, small banks play a major role in derivatives market. For example, in Mexico a lot of affiliates operate from a single office and offer a wide range of tailor-made products for large corporations. Although they hold only 5% of total assets in the banking system, their share in derivatives markets is 33%.

It is also worth mentioning, that recent research on competition in the banking industry, highlights the presence of foreign owned institutions, as a mitigating factor of the possible negative effects of increased market concentration.

2.3. Improving solvency, liquidity and stability

Foreign banks are expected to strengthen financial stability in EMEs, by improving solvency and liquidity of host country's banking system. Banking sectors' solvency improves , because foreign banks are better capitalized, than their domestic peers. They also provide "reputational capital" due to their long presence in the financial market of mature economies. Liquidity is enhanced, because of depositors' trust in the stability of foreign institutions, they believe that in the case of local crisis or shortage of capital, foreign banks will have access to parent's banks money, or will be able to borrow on international financial market. So, the foreign banks mitigate the risk of sudden stop and capital flow reversals.

It is evident that foreign banks have stabilizing influence during local financial crisis. As we already said, they tend to access to more diversified pool of liquidity, than do domestic banks. Even if external funds dry up, they may still have access to financial support.

As a result of increased depositor's confidence, because of the reputation, power, but also because of attractive saving packages that offer foreign banks, the amount of total deposits in the host country, tends to increase. The depositors believe that "if a subsidiary of a foreign institution fails, it is assumed that to maintain its reputation, the parent bank will assure the solvency of the subsidiary. In the case of branches or agencies, it has the obligation to do so"(Makler and Ness 2000).

3. What negative effects can bring foreign banks entry

Although many EMEs are embracing foreign banks entry, its causes and effects are still being debated. Policymakers in EMEs are often concerned about the possible harmfull side effects, that comes together with the foreign banks entry. The issue whether positive effects that brings foreign banks entry, are bigger than negative is still not resolved.

In the following section, we will try to describe some of the most common negative effects from foreign banks entry.

3.1. Exposure on external risk and crisises

As banking has become more globalized, so too have the consequences of global shocks. Indeed, MNBs played a significant role in the transmission of the many crises. Buy permitting foreign banks entry, host countries may open themselves to economic fluctuations in entrants' home country. The greater participation of foreign institutions, the greater expose for the host country to events taking place in other countries, where their foreign banks operate.

When one country relly on foreign banks, is extremely expose on "cut and run" risk, that risk is not associated with the domestic banks. When ownership of a banking system is highly concentrated in a single foreign country, an adverse shock to that foreign country could easily spill-over and engulf the host country economy.

Voger and Winkler[2] analyzed whether a presence of foreign banks in EMEs banking sector had an impact on the stability of cross-border flows and domestic lending after Lehman collapse. Based on a simple of 84 EMEs, they found that a higher share of assets held by foreign banks, was associated with more stable cross-border banks flow, during the crisis period. This result is largely driven by two regions: Eastern Europe and Sub-Saharan Africa. By contrast, foreign banks, had no stabilizing impact on domestic banks lending. Thus, the evidence indicates that the financial stability benefits of a stronger foreign banks presence, did not spill-over from cross-border domestic credit flows. Overall, results indicate that foreign banks provided some additional stability in the crisis. Moreover, there is no evidence that a stronger presence of foreign banks, was associated with a higher degree of instability, compared with the countries, where the role of foreign banks is less pronounces. This is remarkable because the crisis has been global one, triggered in mature economies, with severe negative effects on the strength of the parent bank of subsidiaries in EMEs.

The global financial crisis provides the first, significant test of the financial stability effects of foreign banks in EMEs after the substantial increase in foreign ownership. Now, we can all be satisfied, because transmission of the global financial crisis has jumped EMEs, the consequences of the crisis were less painful, than in the mature economies, which came mainly from foreign banks.

There are also other studies that examine the problem of "cut and run", during the crisis. De Haas and Leluveld (2002) , found that large foreign banks, that have established local presence are less likely to reduce their exposition or to "cut and run" during crisis period, perhaps due to large fix costs of establishing a branch network and gaining market share. Peek et al. (2000) found that offshore lending was more volatile, than onshore lending for Brazil, Argentina and Mexico.

Although many studies claim that foreign banks presence in the EMEs in not associated with greater risk of external crisis, policymakers are still very

[2] Vogel U., Winkler A., " Foreign Banks and Financial Stability in Emerging Markets: Evidence from the global financial crisis", The seventeenth Dubrovnik Economic Conference, Croatian National Bank, July 2011

cautious. In order to assure them, foreign banks often provide "comfort letter" assigned from their holding company , that they would assist their subsidiary in case of distress.

However, some experts have already provided examples in which such commitments prove to weaker, than commonly though. Accourding to them "comfort letter" represent nothing more than a moral statement. Thus support from a parent bank to its subsidiary should not be taken as a guarantee. The local regulators should we aware that the foreign investor's decision to support a subsidiary will be solely made on the balance of future profit and their legal and reputation costs. In order to limit reputation costs, some MNBs are using different brand names. Other strategy to reduce reputations cost consist in selling subsiadiary at a low price or even paying investors to acquire them, instead of letting them fail.

3.2. Neglecting credits for small and medium sized entrepreneurship

SMEs[3] play a major role in EMEs as they represent around 90% of the total firms population and generate a large share of employment(more than 50% in many countries) and value added in the economy. These firms are significant source of innovations. Access to credit is crucial for SMEs survival. Key supplier of credit to SMEs is the commercial banking system. Given the SMEs meaning for the economy, reduced acces to credit for these firms could have a considerable impact on the overall economy.

Several authors have stressed the possibility of higher financing for SMEs, as foreign banks may serve only large and transparent customers. Focarelli and Pozzolo (2000) suggest that EMEs should be more careful before they allow foreign banks entry, because they can drive SMEs out of business by reducing their financial cash-flows. According to those authors, the main reasons why foreign banks entry can reduce the amount of credit for SMEs, is that foreign banks may shy away from lending to small business firm. For large banks organizational diseconomies may make it difficult to provide lending services to small businesses.

Evidence of small businesses lending in Latin America finds that SMEs are less likely than large ones to receive credit from foreign bank, but although they allocated a smaller share of their loan portfolio to SMEs, than domestic banks, they granted almost half of credits in 2000. The amount of lending to SMEs may increase even if their share of lending decreases. Foreign bank participation may cause domestic bank to modify their behavior. In particular, foreign competition for large clients may force existing domestic banks to seek new market niches, which could benefit small borrowers in the medium term.

[3] SME – Small and medium sized entreprenership

Perhaps one of the most complete studies in terms of the number of countries analyze, was done by Clarke et al. (2002) who used survey data of more than 4000 firms operating in 36 countries. The autors found that foreign banks participation decreased the financing constraints of all firms in the economy. Although they reported evidence which suggest that entry by foreign banks benefits large enterprises more than small enterprises, they did not find indications of any harm to SMEs finance.

Even if foreign banks enter in the domestic market in order to serve large corporate clients, increased competition in the wholesale market may force domestic banks to channel resources to SMEs.

3.3. Impact of parent banks' business strategies on host country entities

As market and institutions became global, business decisions increasingly disregard country border. Business strategies, accounting and risk management are done on a consolidated basis and economic transactions are booked where regulation is less costly.[4]

The policymakers are also concern that MNBs are measuring the exposure to different risks factors on a global basis, consolidating all their positions, disregarding where these positions are booked. MNBs also allocate resources following risk/return conditions at their various subsidiaries. Such strategy can harm or even close some of the subsidiaries. Problems increases when those decisions affects the interest of local stakeholders, so the concequences can harm worst host economy.

Although this global strategy that is applied bu MNB make sense from a global perspective, they can harm very badly, weak economies of developing countries, especially during the times of stress, crisis and shocks.

[4] Cardenas J. Graf J.P. O'Dogherty P., "Foreign banks entry in emerging markets economies: a host country perspective.

Conclusion

The past two decades have seen a great influx of foreign banks into EMEs, a trend likely to continue. The main reason for this upward trend of foreign banks entry is opening the capital market in EMEs which allow foreign banks entry, either through merger and acquisitions, or via Greenfield investment. Since then a big wave of foreign direct investment in financial sector in EMEs has occurred.

Foreign bank can enter in an emerging economy by different organization forms, depending of the level of risk that they are willing do bear, and depending of the type of operations, that they are planning to take in the host country. Foreign banks can establish representative office,agency, branch or subsidiaries in the host country.

What benefits is foreign entry likely to bring, and what risk does it pose? This is surely the most important question that still is not fully answered. Many results from the studies of developed countries do not appear to carry over to EMEs. So we should not rely on such studies, since they can underestimate benefits from foreign banks entry for the EMEs.

Foreign banks entry improves efficiency and profitability in banking sector. The efficiencies benefits are correlated whit bringing new technologies, products and management techniques as well as from increased competition stimulated by new entrants.

Improving competition is benefit that is closely related whit the previous ones. As more participants are entering in the financial market, they will have to compete amoungst themselves with and end result being new, more sophisticated and cheaper financial services for the customers.

Foreign banks are also seen as a source od stability, solvency and liquidity. Generally, studies had shown that during the local crisis, foreign banks act as a stabilizations since they can access financial capital from parent bank, but also from international capital market, where have easy access because of reputation and brand name.

Although foreign banks can be seen as a source of stability, they can also foster contagion. That is especially the case when there is crisis in the home country or a crisis in another country, where parent bank has a subsidiary. The risk of transmission the crisis rises if a single foreign country control more banks in the country, so in the case of shock in the foreign country, that shock could easily spill-over and engulf the host country economy.

The initial empirical evidence on the effect of foreign entry on access to credit by SMEs suggest fewer reasons for concern than previously thought. Although foreign banks tend to be large, and large banks lend smaller share of their portfolio to SMEs than do other banks, studies suggest that the amount of lending to SMEs may increase even if their share of lending decreases. Foreign bank participation may cause domestic bank to modify their behavior. In particular, foreign competition for large clients may force existing domestic banks to seek new market niches, which could benefit small borrowers in the medium term.

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