The increased role of foreign bank entry in emerging markets

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Foreign banks and credit markets

The past decade has seen a transformation of the role of foreign banks in emerging markets. It has been a process that has often aroused considerable controversy, and featured prominently in two earlier meetings of Deputy Governors (1998 and 2000).[2] The benefits foreign banks can offer are now much more widely recognised. But it would be naive to pretend that there are no drawbacks or no difficult choices for local supervisory authorities. The supervisory response to the rapid rise of foreign banks is still being refined - and, in some countries, remains an important task.

Foreign banks have become well established as key vehicles in the international integration of the financial systems of emerging market economies. There has been a strategic shift by foreign banks away from pursuing internationally active corporate clients towards the exploration of business opportunities in the domestic market. One standard indicator of foreign bank presence is the share of assets of foreign-controlled banks (Annex Table A1), which has increased significantly in many countries. Another indicator of foreign influence is the ratio of local claims of BIS reporting banks to domestic bank credit; this is shown in the last column of Table 1.

It is clear that the degree of foreign penetration has differed sharply across regions. There has been a radical transformation in Latin America and central Europe in the space of a very few years. Privatisation (in the Czech Republic, Hungary, Poland, Brazil and Peru) and the need to recapitalise the financial system following financial crises (Mexico and Korea) have been important driving forces. In Asia, by contrast, the penetration of foreign banks has been much less (8%). The main exceptions are Hong Kong SAR, Singapore, Thailand (where the ratio has risen) and Malaysia.

A development of great importance has been that lending by big local affiliates has progressively displaced direct dollar-denominated lending by the head offices of international banks (Table 1, column 3). This is potentially a positive development as it can mean greater borrowing in local currency and thus smaller currency mismatches. In addition, the deeper local presence of international banks may contribute to greater efficiency and resilience of the financial sector.

The greater scale and changing character of foreign participation in banking systems raise many questions: about the impact on the efficiency of financial institutions; about the macroeconomic effects on aggregate lending and on the responsiveness to monetary policy; and about the implications for financial sector stability. The following paragraphs outline some of these issues.

The impact on efficiency and aggregate lending[3]

A larger foreign bank presence can enhance the competitiveness of the banking sector. Greater competition is desirable for a number of reasons: to enhance the efficiency of financial services; to stimulate innovation; and to contribute to stability. It can also widen access of qualified borrowers to

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[2] The papers for these meetings are in BIS (1999) and BIS (2001). A summary is Hawkins and Mihaljek (2001), pp 24-32.

[3] Additional perspective on the benefits of foreign bank entry is provided by CGFS (2004), Goldberg (2003), Chua (2003), Cardenas et al (2003), and Kim and Lee (2003). CGFS (2004) and other country reports also discuss issues from the home country perspective which are outside the main focus of this paper. Wolf (2004) is very persuasive on the need for substantial inward FDI in the financial sector (see especially Chapter 13).

financing, which may increase aggregate lending and so enhance growth.[4] A more competitive and efficient banking system can also improve the effectiveness of monetary policy transmission by tightening the link between policy rates and deposit/lending rates.

Table 1

Claims on BIS reporting banks[1]

	International claims[2]			Local claims[3]			Local claims/ international claims			Local claims/ domestic bank credit		
	1995	**2000**	**2003**	**1995**	**2000**	**2003**	**1995**	**2000**	**2003**	**1995**	**2000**	**2003**
	in billions of US dollars						**in percentages**					
Asia[4]	**730**	**471**	**422**	**160**	**308**	**360**	**22**	**65**	**85**	**8**	**10**	**8**
China	48	58	49	0	3	6	1	6	12	0	0	0
Hong Kong SAR	241	110	88	96	165	167	40	150	190	48	66	72
India	16	22	22	8	17	24	54	76	106	7	8	8
Indonesia	45	40	29	4	5	6	8	11	20	3	6	7
Korea	78	59	65	8	18	29	11	31	45	3	5	5
Malaysia	17	21	22	4	29	33	25	139	152	5	30	29
Philippines	8	17	17	1	5	5	17	32	28	4	13	12
Singapore	192	100	91	22	32	46	11	32	51	26	29	37
Taiwan, China	23	18	21	10	16	26	44	90	120	2	3	6
Thailand	63	27	17	5	17	19	9	62	113	3	13	15
Latin America[4]	**195**	**260**	**195**	**38**	**222**	**243**	**20**	**85**	**125**	**8**	**41**	**52**
Argentina	38	69	25	4	23	13	10	34	55	7	29	32
Brazil	57	68	52	21	72	52	36	107	100	9	31	23
Chile	14	22	20	8	28	23	58	124	112	25	64	55
Colombia	11	12	8	1	5	5	8	46	59	5	25	21
Mexico	57	64	68	4	80	142	8	126	210	3	58	119
Peru	6	13	11	1	3	3	10	24	27	7	22	21
Venezuela	12	13	12	0	10	6	3	76	48	2	66	77
Central and eastern Europe[4]	**76**	**92**	**119**	**4**	**52**	**93**	**5**	**56**	**78**	**3**	**33**	**35**
Czech Republic	8	11	16	2	15	32	31	135	206	6	53	80
Hungary	9	17	27	1	8	14	8	47	52	5	41	35
Poland	7	24	35	1	27	44	12	112	125	2	48	55
Russia	52	40	41	0	1	2	0	2	6	0	2	2
Other[4]	**60**	**95**	**87**	**2**	**7**	**8**	**3**	**8**	**9**	**1**	**2**	**2**
Algeria	13	5	4	0	0	1	1	7	14	1	2	
Israel	5	8	10	0	0	1	0	3	5	0	0	0
Saudi Arabia	8	17	16	0	0	0	1	0	0	0	0	0
South Africa	16	18	20	1	4	4	6	20	21	1	5	4
Turkey	19	47	37	1	3	2	3	6	6	2	3	3

[1] Outstanding positions at year-end; for 2003, end of June. [2] BIS reporting banks' cross-border claims in all currencies and their foreign affiliates' local claims in foreign currencies (consolidated banking statistics). [3] BIS reporting banks' local claims in local currencies. [4] Total of the countries shown.

Sources: IMF; BIS.

[4] However, performance measures such as bank margins or profitability may not always measure competitiveness adequately, because performance may be influenced by other factors such as macroeconomic conditions, taxation and institutional factors.

A number of studies have investigated empirically the effects of foreign bank entry on the efficiency of the financial sector. The evidence generally suggests that increased entry, including by foreign banks, is associated with greater competition. For example, using a data set of regulatory restrictions applied in 107 countries in 1999, Barth et al (2001) find that tighter entry restrictions are associated with lower bank efficiency (higher interest rate margins and overhead expenditures). Claessens et al (2001) find that foreign bank entry tends to reduce profit margins in the banking sector. Demirgüc-Kunt et al (2003) find that greater bank concentration is associated with lower bank efficiency in emerging economies. Claessens and Laeven (2003) find that greater foreign bank entry and lack of entry and activity restrictions are associated with more competition.[5] Moreover, there is evidence that competitive pressures are greater in those areas where foreign banks are active.

Foreign bank entry can also help countries recapitalise their banking systems in the aftermath of banking crises, providing the basis for a revival of bank credit. For example, in 1995 the Mexican banking system became insolvent as a result of bad loans and the very high interest rates that followed the collapse of the Mexican peso. Notwithstanding considerable government support, bank credit to the private sector did not grow for several years. As the system was opened to foreign participation, the stronger capital base and the removal of bad loans provided incentives for banks to resume lending. As reported in Table 1, the ratio of local claims of foreign-owned BIS reporting banks to credit provided by domestic banks in Mexico is 119%. Banks that are more than 50% foreign-owned control nearly 82% of banking sector assets (Annex Table A1).

In stark contrast, however, reliance on foreign banks has been much less in Asian economies affected by the 1997 crises. The ratio of international bank local claims to domestic bank credit is 30% in Malaysia, 15% in Thailand and still lower in Korea, Indonesia and the Philippines. One interesting question is why there has been less reliance on foreign banks in Asia after the Asian crisis than in other regions after crises in those regions. Possible explanations could include the high domestic saving rates (which kept banks liquid) and large government-financed bailouts.

The impact on financial and economic stability

Foreign bank entry may enhance financial stability by permitting greater diversification of exposures and by improving risk management. It could also contribute to making more capital or liquidity available when needed.

A foreign bank presence could be particularly valuable during periods of banking stress, to diversify against country-specific (systemic) risks that can severely impair the capital of the banking system. The fact that foreign banks are diversified across different countries could well change the cyclical behaviour of the host country financial system since foreign banks are less sensitive to host country cycles. How valuable this proves to be in practice depends on how closely the domestic economic cycle is correlated with the global economy. Counter cyclical changes in foreign bank lending could also help to amplify the effectiveness of monetary policy. Foreign banks could also be more resilient during currency crises. Not only do they tend to be more aware of currency mismatches, they can also call on their parent organisations to provide foreign currency liquidity.

A number of empirical studies suggest foreign banks do indeed play a stabilising role. Using BIS banking statistics for a set of Latin American countries over the period 1985-2000, Martinez Peria et al (2002) find that, while foreign banks transmit external shocks to their host countries, they become more responsive to host country conditions over time and their lending reacts more strongly to positive than to negative host shocks. They also find that foreign bank lending is not significantly curtailed during crises; hence greater foreign bank participation may be associated with a reduced probability of crises (Levine 1996).

The behaviour of foreign banks during certain crisis episodes illustrates the potentially stabilising role they can play. For example, Detragiache and Gupta (2004) find that foreign banks did not abandon the local market during the 1997-98 crisis in Malaysia and received less government support than

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5 Their measure of bank competition differs from others because it is based on a structural contestability approach. It tests whether an increase in input prices raises both marginal costs and total revenues by the same amount as the rise in costs (perfect competition), or whether an increase in input prices increases marginal costs, reduces equilibrium output and therefore total revenues (monopoly), or whether the response is somewhere in-between.

domestic institutions.[6] In another instance, that lending by foreign banks in Argentina and Mexico grew faster than lending by domestic banks during the 1994-95 crises (Goldberg et al (2000)). The behaviour of foreign banks in Argentina during that earlier period is confirmed by the paper by Lacoste in this volume.

There are nonetheless three important questions about the role of foreign banks.

First, a large foreign banking presence could mean that information available to host country supervisors can be reduced to the extent that decision-making and risk management shifts to the parent bank. The delisting of the equity of local affiliates on the local exchange removes an important source of market intelligence. In addition, if the integrated firms' equities are delisted in the local market, host country supervisors can also lose access to key foreign bank decision-makers.

Second, a large foreign bank presence can expose a country to shocks due to purely external events, such as those affecting the parent bank. The factors that determine vulnerability to such external shocks, whether the exposure is greater with onshore foreign banking as compared to traditional cross-border bank lending, and the implications for regulatory and supervisory policy also warrant further investigation.

A third issue is the regulatory treatment of foreign currency denominated lending. A borrower that chooses dollar borrowing to cover local currency business makes itself a worse credit risk - but this is often not sufficiently recognised either by the bank in its risk management techniques or by the regulators. As Basel II aligns capital requirements more closely to differences in credit risk than Basel I, regulatory distortions should be reduced. And over time the more systematic use of default data should clarify which foreign currency loans should be regarded as a worse credit risk than local currency loans.[7]

The first two concerns have been cited by a report on FDI in the financial sector by the Committee on the Global Financial System (CGFS (2004)) and apply to a number of countries, including Mexico and New Zealand (see Cardenas et al (2003)) and Bollard (2004).

The series of events that culminated in Argentina's financial crisis in 2001 raises several important questions. Lacoste finds that foreign banks played no stabilising role in these circumstances.[8] The explanation for this conclusion - which contradicts what might have been explained - is not clear. In what ways might the response depend on the nature of the shock and on the economic policies followed by the host country government? How are regulatory constraints, or the relative ability or incentive to access lender of last resort facilities, affected by the shift from cross-border to onshore operations? What does this imply for the reaction of foreign banks during periods of financial stress? Answers to these questions would have an important bearing on risk management by foreign firms and the oversight of foreign regulators.

Another line of research suggests that foreign bank entry might contribute to greater stability by increasing profits, and improving capital cushions, in the banking sector. There is some evidence that the rationalisation of banking services following foreign entry (or foreign competition) lowers overhead costs and so improves profits. A less satisfactory outcome would be that foreign banks raise profits by reducing competition, which appears to occur in some cases.[9] Levy Yeyati and Micco (2003) study the evidence for eight Latin American countries and find that foreign bank penetration appears to have led to less competitive banking sectors. The higher profits strengthen the financial position of banks and lower their risk level. Lower risk is not necessarily due to safer lending by foreign banks compared to

[6] They also find that the banks not specialising in Asia were more profitable than banks that did specialise in Asia during the crisis, enjoying higher interest margins and fewer non-performing loans.

[7] This issue is discussed in Goldstein and Turner (2004), pp 85-8.

[8] Some empirical evidence that foreign banks may accentuate economic volatility (as measured by year-to-year fluctuations in real GDP and investment) in emerging economies is provided by Morgan and Strahan (2003), who study nearly 100 countries over the period 1990-97. More precisely, volatility is the square or the absolute value of residuals from a first-stage growth regression of GDP growth (or investment growth) on a set of time fixed effects, country fixed effects, a measure of banking integration, and other control variables. However, this study does not directly examine the importance of flows associated with the foreign banking sector.

[9] Claessens et al (2001) argue that foreign banks in emerging markets have higher net margins and profitability, as well as higher overhead costs, so their higher returns do not appear to be due to higher efficiency.

domestic banks but rather to higher profits and charter value that the average foreign banks can obtain. Foreign banks can do this because their products are not perfect substitutes for the products offered by domestic banks.

Foreign bank entry may also lower risk through improved risk management techniques and more realistic provisioning against bad loans. As those techniques become more deeply rooted in the local banking culture (and perhaps as the quality of supervisory oversight improves), the stability of the local financial system should improve. Nevertheless, two issues are sometimes raised. First, the expertise and the extra resources of foreign banks might allow them to take the more profitable and creditworthy borrowers away from domestic banks, adversely affecting the profitability of the latter. Kim and Lee (2003) suggest that foreign banks may have had this effect in Korea. Second, foreign banks could concentrate their lending on large enterprises, instead of small and medium-sized enterprises and other creditworthy borrowers that are "informationally opaque". This argument, which was once a fashionable critique of foreign banks, now appears less convincing as foreign banks increasingly demonstrate their ability to expand their business with households. In this business, foreign banks have brought improvements in credit scoring techniques and in securitisation techniques.

There is, however, no decisive cross-country empirical evidence that foreign bank entry adversely affects lending to small and medium-sized enterprises.[10] One study uses data from four Latin American countries to confirm that foreign banks in fact do lend less to small businesses. However, this reflects the behaviour of small foreign banks, which may lack the resources to evaluate small borrowers. Another study estimates how borrower perceptions of credit conditions are affected by foreign bank entry, drawing on a survey of over 4,000 enterprises in 38 developing countries' economies. It concludes that foreign bank penetration improves the access to credit for all firms. Small firms benefit even if large firms benefit more.

Policymakers in emerging economies have sought to enhance credit availability to small borrowers by seeking to reduce credit risk in two ways: (1) making information available to facilitate the assessment of the creditworthiness of borrowers in the economy, for example via the establishment of credit bureaus; (2) making it more costly for borrowers to fall behind in their payments, for example by improving the ability of lenders to attach assets.

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[10] Clarke et al (2001) and Clarke et al (2002).

Annex

Table A1

Foreign ownership of banks

	Assets owned by banks with 50% or more foreign ownership[1]			Assets owned by banks with more than 10% but less than 50% foreign ownership[1]		
	1990	**2000**	**2002**	**1990**	**2000**	**2002**
China	.	.	.	.	.	.
Hong Kong SAR	45.7	87.2	88.6	3.7	7.2	6.2
India	21.0	42.0	40.0	.	4.0	5.0
Indonesia						
Korea	.	32.7[2]	32.3	.	7.5[2]	14.4
Malaysia	22.3	24.9	25.2	34.1	30.5	38.7
Philippines						
Singapore	89.4	75.7	76.0	…	…	…
Thailand	–	5.9	5.8	.	45.8	48.6
Argentina	17.0[3]	48.1	41.6	.	13.4	12.7
Brazil		25.2	21.5		7.0	6.2
Chile	18.6	33.1	44.8	5.5	16.5	3.0
Colombia	3.7[4]	18.0	16.4	6.6[4]	13.7	13.6
Mexico	0.3	54.6	81.9	.	0.3	0.6
Peru	0.0	32.6	30.4	10.5	9.2	14.4
Venezuela		49.7	37.4		7.7	0.8
Czech Republic	26.4	65.4	85.8	63.7	22.1	8.3
Hungary	11.4[5]	69.9	90.4	8.2[5]	23.8	–
Poland	0.02	69.5	67.4	0.02	1.4	2.1
Russia	7.2[6]	9.5	8.1	5.5[6]	3.1	2.3
Israel	.	.	.		20.2	12.8
Saudi Arabia	–	–	–	7	6	6
South Africa						
Turkey	2.9	3.6	3.3	0.8	–	–

Note: . not available; – nil; … not applicable.

[1] As a percentage of total banking sector assets, at end-year. [2] 2001. [3] 1991 as a percentage of deposits. [4] 1992. [5] 1993. [6] 1998.

Source: Central banks.

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