หอสมุดกลาง สถาบันวิทยบริการ จุฬาลงกรณ์มหาวิทยาลัย

Chapter 1

Introduction and overview

1.1 Preface

This study is concerned with the consequences of further opening the Thai banking sector to foreign direct investment. Being one of the most important sectors of the Thai economy and providing crucial services to the economy (such as mobilizing and allocating savings), with total commercial bank credit amounting to 112 percent of nominal GDP[1], the significance of the banking sector has lately been underscored by its role in triggering the Thai financial crisis in 1997.[2]

Liberalizing foreign entry into the banking sector is only one facet of the process called internationalization of financial services, along with eliminating other discrimination in treatment between foreign and domestic financial services providers, and removing barriers to the cross-border provision of financial services.[3] The internationalization of financial services is an important, but controversial issue for the strengthening of financial systems in developing countries. On the one hand, there is the view that internationalization can assist countries in building financial systems that are more stable and efficient. Common arguments in favour of foreign bank participation in particular are that foreign banks may[4]

- improve the quality and availability of financial services and lower costs and excessive profits (associated with cartelized and oligopolistic banking systems) in the domestic market, by introducing more sophisticated banking technologies (e.g. advanced risk management systems) and increasing bank competition, which in turn lowers the cost of investment and improves resource allocation,
- introduce international standards and best practices,

- encourage the development of ancillary institutions that promote the flow of information such as rating agencies, accounting and auditing firms, and credit bureaus,
- play an important role in allowing banking systems to recover from crises,
- contribute to an improvement in the overall quality of the loan portfolios of domestic banks, because foreign banks are less likely to be forced by the government to lend to connected or preferred borrowers,
- contribute to the stability of the domestic financial system (e.g. if, in periods of crisis, depositors shift their funds to foreign institutions that are perceived to be more sound, rather than transferring assets abroad), and
- increase the amount of funding available to domestic projects.

On the other hand, there have been concerns about the risks that internationalization may carry for some countries. Arguments against foreign bank penetration in part mirror the arguments mentioned above. Potential drawbacks are that foreign banks may[5]

- create pressure on local banks to merge in order to remain competitive, or force domestic banks to cease operations (A higher degree of concentration in the banking system may adversely affect output and growth due to higher interest rate spreads and a lower amount of loans generated.),
- have a tendency to “cut and run“ during a crisis,
- pose a threat to national security and cultural integrity,
- ration credit to small and medium-sized enterprises, and concentrate instead on larger and/or stronger ones (and leave less competitive institutions to serve more risky customers, leading to excessive risk-taking), which may have an adverse effect on output, employment, and income distribution,
- expose the host country to economic shocks in the entrants‘ home countries,
- diminish the ability of local regulatory and monetary authorities to influence bank behaviour, and
- lead to more financial distress among domestic banks in cases where the domestic financial system is currently undercapitalized.

Although the number of countries embracing foreign bank entry is growing, many questions regarding this process are still being debated.

This study aims at shedding some light on the process and it focuses on the impact on pricing, quality, and availability of commercial banking services. Other issues, such as the introduction of international standards and best practices, development of ancillary institutions, and pressures on domestic banks to merge are also discussed.

The study is organized as follows. The remainder of Chapter 1 presents background, objective and scope of the study. The literature review is presented in Chapter 2. Chapter 3 provides an overview of developments in the Thai banking sector, with a focus on foreign bank entry and differential treatment of foreign-owned and domestic-owned banks. Chapter 4 presents the empirical model, the estimation results and an assessment thereof. The qualitative effects of foreign bank entry are analysed in Chapter 5, and Chapter 6 concludes.

1.2 Statement of the problem

Developed and developing countries alike increasingly allow domestic banks to be foreign-owned – frequently, as in the case of Thailand, as a direct consequence of and a perceived solution to financial crises, due to the need for large-scale recapitalizations of troubled financial systems.

Until recently Thailand had been relatively closed to foreign banks. Foreign bank participation had been restricted inter alia by a limitation of one branch in the capital city, the fact that the last bank license was granted in 1978, and the fact that foreign ownership of domestic banks had been limited.[6] Regarding the latter, foreign persons could not hold more than 24.99 percent of paid-up registered capital or more than 24.99 percent of directorship positions.[7] These restrictions have been removed by the Emergency Decree amending the CBA B.E. 2505 (No. 2) B.E. 2540[8] and the guidelines for equity holding in financial institutions set by the BOT with the approval of the MOF, as announced on 11 November 1997[9]. Since then, foreign investors that have a sound financial status and a high potential to help increase the efficiency in the management of financial institutions are allowed to hold more than 49 percent of the shares of a financial institution for a period of 10 years. After 10 years, foreign investors will not be forced to sell their shares, but are not allowed to purchase additional shares, unless the amount of foreign shareholdings is less than 49 percent of total shares (grandfathering).[10]

In its Letters of Intent to the IMF, Thailand repeatedly stressed that:

- foreign bank entry is encouraged to increase efficiency and competition in the financial sector
- liberalization of foreign equity investment in the financial sector is crucial for the restructuring of the financial sector, especially given the limited availability of domestic capital
- market opening policies can make a significant contribution to ending the recession, accelerating economic recovery, and restoring sustained medium-term growth.

This change in attitude was followed by an intense period of foreign entry:[11]

- in January 1998 the Development Bank of Singapore acquired a majority stake (50.03%) in the Thai Danu Bank (renamed DBS Thai Danu Bank)
- in June 1998 ABN Amro Bank acquired a majority stake (75%) in the Bank of Asia
- in September 1999 Standard Chartered Bank acquired a majority stake (75%) in the Nakornthon Bank (renamed Standard Chartered Nakornthon Bank)
- in November 1999 United Overseas Bank acquired a majority stake (75%) in the Radanasin Bank (renamed UOB Radanasin Bank).

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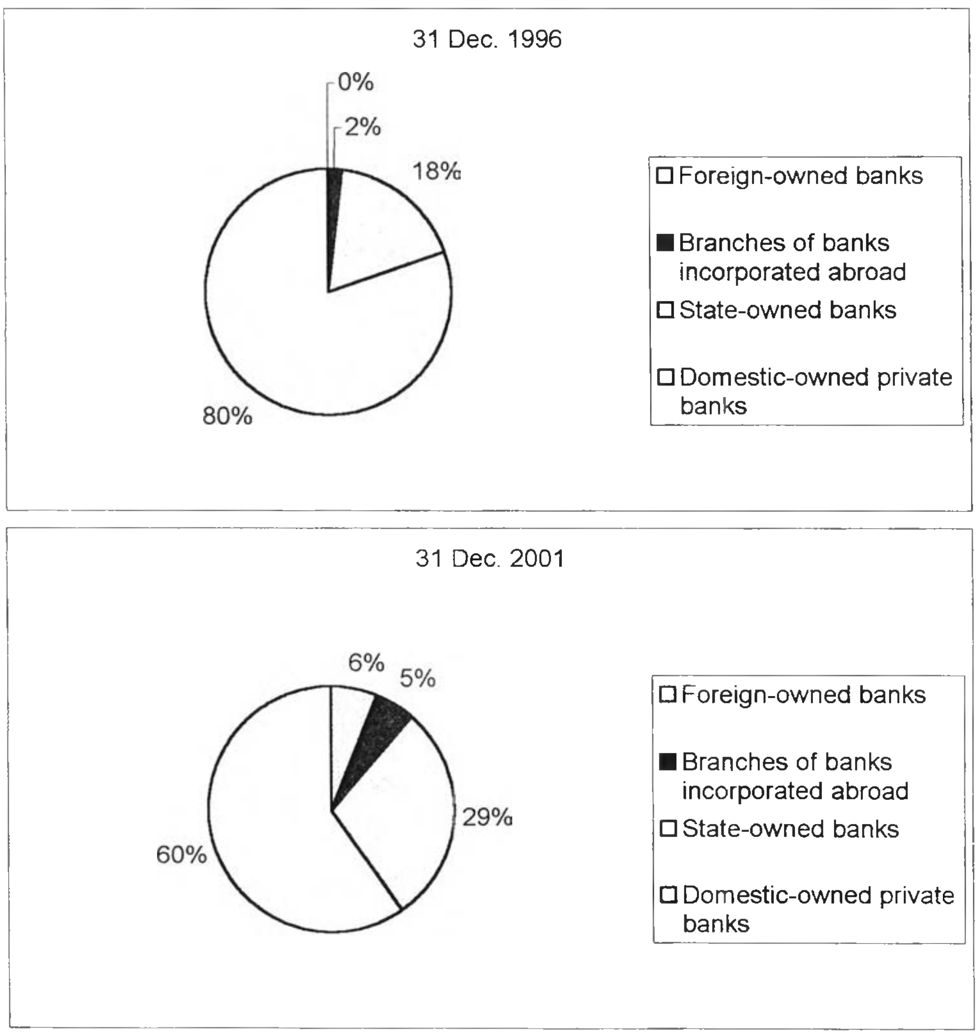
The sales of Bangkok Metropolitan Bank and Siam City Bank, which appeared to be close to completion at the end of 1999, eventually disappeared from the headlines[12], but the sale of the recently merged entity remains pending as well as the planned privatizations of Krung Thai Bank and BankThai.

Figure 1 Thai commercial banking sector: Deposits as of 31 December 1996 and 2001[13]



As can be seen from Figure 1, the share of total commercial banking system deposits under direct foreign control increased from 2 percent in December 1996 to 11 percent in December 2001.

Further liberalizing foreign equity investment in financial institutions for a period of 10 years gives foreign banks for the first time the opportunity to compete, especially in retail banking, on an almost level playing field. Foreign banks acquiring a domestic bank gain instant access to branch networks, permitting them to reach previously hardly accessable retail markets.[14]

Summarizing, changes in the restrictions on domestic bank ownership have been motivated by the desire to improve the level of competition and efficiency in the banking system and by the need to restructure and recapitalize domestic banks in the wake of the financial crisis. Hence, financial liberalization of the kind as observed in Thailand in 1997 only proceeds on the premise that the gains to domestic market participants outweigh any losses to domestic banking institutions.

1.3 Objective of the study

The objective of the study is threefold:

(1) to find out if foreign-owned banks incorporated in Thailand differ from domestic-owned banks incorporated in Thailand[15] in terms of efficiency (measured by net interest income, overhead expenses, and profits – all scaled by total assets),

(2) to examine if foreign bank entry affects the efficiency (in terms of net interest income, overhead expenses, and profits – all scaled by total assets) of the domestic banking system in Thailand[16], and

(3) to analyse the qualitative impact of foreign bank entry.

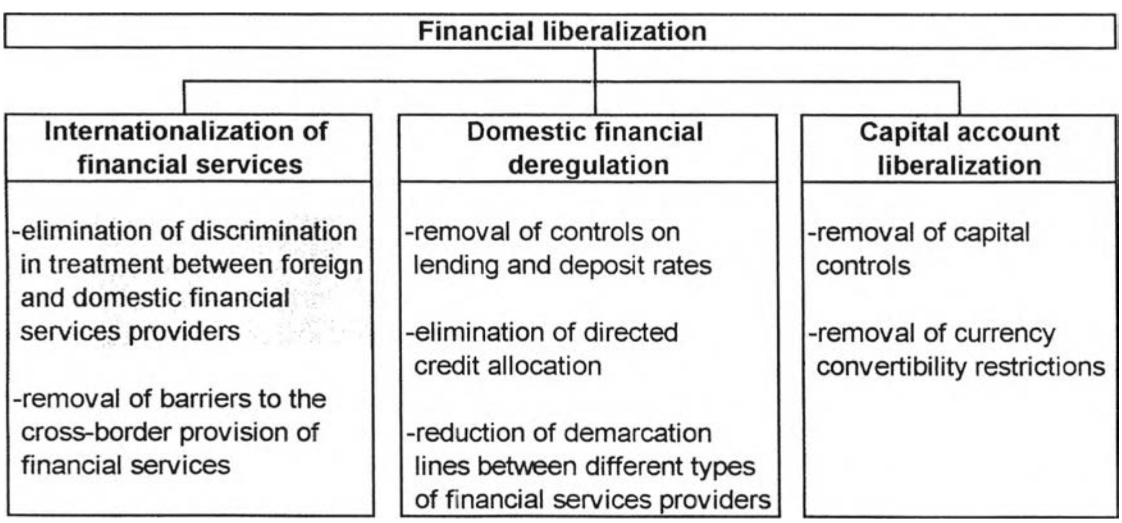
1.4 Scope of the study

Foreign bank entry refers to a process by which foreign banks set up operations in a host country mainly by either opening a branch, establishing a subsidiary, and/or acquiring a subsidiary. This country case study on the Thai commercial banking sector focuses, not exclusively however, on the mode of entry in form of acquisitions of established domestic banks by foreign banks (at least 50 percent of outstanding shares) during the period 1997 to 2002, using quarterly data.

1.5 Conceptual background

The internationalization of financial services in general and of banking services in particular, which includes liberalizing foreign entry, is one aspect of the process of financial liberalization, along with capital account liberalization and domestic financial deregulation, which are interrelated. The conceptual starting point thus lies within the broader context of financial liberalization as outlined in Figure 2.[17]

Figure 2 Framework of financial liberalization[18]



The first international effort to embody core principles of non-discrimination in financial services (such as most favoured nation status and national treatment) is GATS, which was negotiated within the Uruguay Round agreement of 1993. In 1997 the FSA was concluded within the WTO, which extends GATS. Although the FSA includes market-opening commitments and a mechanism for dispute settlement, its contribution remains modest as members just placed existing policies into an international agreement.[19]

The theoretical starting point lies in the theory of comparative advantage and whether the conclusions reached with respect to international trade in goods apply to international trade in financial services. The evidence of research on international trade in services in general suggests that the broad conclusions of the theory of comparative advantage also hold, but have to take into account differences between goods and services.[20] International trade in services, and especially in financial services, differs from international trade in goods in the following ways:

- the provision of services often requires a local presence, and
- the provision of financial services is highly regulated, often imposing the establishment of a local presence,

which affect the trade in services across borders as well as the local provision of services by a foreign services provider.[21]

The study further draws on the theory of the multinational enterprise and the theory of industrial organization.