Chapter 2

Literature review

Existing literature has been primarily focused on developed countries, particularly the United States. Only recently, cross-country research and country case studies have been extended to developing countries and significant differences have been revealed (i.e. many of the developed country results do not carry over to developing countries). Interestingly, all of the empirical studies reviewed point to beneficial effects of foreign bank entry.

◆ The following studies on the effects of foreign bank entry focus on competitive pressures exerted by foreign banks and their impact on financial sector efficiency.

In a recent country case study, **Denizer (2000)** analyzes the impact of foreign bank entry into the Turkish banking market, following the approach used by Claessens et al. (1998). Using yearly bank-level and macroeconomic data and covering the period from 1980 to 1997, he examines the questions (1) Does foreign ownership matter in the determination of performance controlling for other factors?, and (2) What is the impact of foreign bank penetration on the performance of domestic banks controlling for other factors? Focusing on the three performance measures, net interest margin, overhead expenses over total assets, and return on assets, he finds empirical evidence that foreign bank ownership is related to all three performance measures. The more direct examination of the effects of foreign bank entry on domestic bank performance shows that foreign bank entry produced some of the expected beneficial results. The entry of foreign banks had the effect of reducing overhead costs (scaled by the volume of business) in the domestic banking system, implying increasing efficiency and resource utilization. The results with respect to the performance measure return on assets suggest that foreign banks enhance competition and reduce domestic bank profitability.

Directly testing the impact of foreign entry on domestic banks' net interest margin, however, indicates that neither the number share of foreign banks nor the asset share of foreign banks are related to net interest margin in a significant way.

Barajas et al. (2000) study the evolution of foreign direct investment in Colombia's financial sector, analyze differences across types of banks, and the possible impact of foreign entry on three aspects of bank performance: pricing (interest spreads), loan quality and operative efficiency, using semi-annual data for the period 1985 to 1998. Three different panels (all banks, foreign banks (banks in which foreigners own at least 30 percent of total equity), and domestic banks) are used. The first set of regressions follows the approach used by Claessens et al. (1998) and the results give evidence of a beneficial impact of foreign entry. Foreign entry (in terms of market and number penetration) appears to have a significant effect in lowering spreads, reducing non-financial costs, and improving loan quality in the banking system. In a further step, the authors control for other elements of the liberalization process: increased domestic entry, capital inflows, and other aspects such as banking regulation and supervision. Once these elements were incorporated, foreign entry continued to play an important role, increasing competition, and reducing the excess charged over marginal cost in intermediation spreads, particularly by domestic banks. However, domestic entry appeared to have an even greater impact, lowering non-financial costs in addition to intermediation spreads charged by both domestic and foreign banks. Foreign banks are shown to benefit the most from entry as increased competition tended to drive their spreads and administrative costs down and tended to improve their loan quality, thus suggesting that these institutions were in a stronger position to compete in the new environment. As foreign investors acquired domestic banks, they tended to lower the administrative costs of the acquired bank.

Pastor et al. (2000) analyze the impact of the opening of the Spanish banking system in the context of the Single Market Programme. Using the methodology developed by Claessens et al. (1998) the authors investigate

inter alia the influence of foreign entry on (i) net interest income, (ii) gross income, (iii) overhead costs, and (iv) pre-tax profit (all scaled by the volume of business) controlling for selected other factors. The results for the time period 1985 to 1996 indicate that foreign bank entry significantly reduces gross income and, at a 10 percent significance level, net interest income, and overhead costs. Pre-tax profit turns out not to be affected. In a further step, the model is also estimated by clusters (i.e. groups of banks with similar specializations according to a specific set of variables) as it was expected that foreign entry affects, to a greater extent, those banks which perform similar activities to those carried out by foreign banks. The results indicate that only banks included in the same cluster as foreign banks were affected by the intensity of the presence of foreign banks in terms of net interest income, gross income, overhead costs, and pre-tax profit.

Following the analysis by Claessens et al. (1998), **Clarke et al. (1999)** analyze how foreign entry affected domestic banks in Argentina between 1995 and 1997, using quarterly data. Under the leader-follower view (foreign banks follow their domestic clients to finance their trade and service their needs in other countries), it is expected that foreign entrants focus on clients from their country of origin. Thus, such entry should exert little competitive pressure on domestic banks and should do little to improve financial services offered to Argentine consumers. Under the second view, based on the theory of comparative advantage, it is suggested that effects on domestic banks depend on whether they provide services in an area where foreign entrants have a comparative advantage and it is expected that lending spreads and profits would decrease most at those domestic banks whose lines of business are similar to those of foreign entrants. Their results are consistent with the second view that foreign banks enter specific areas where they have a comparative advantage, putting pressure on the domestic banks already focusing on those types of lending. Throughout the period, foreign banks devoted a high share of credit to manufacturing, and the empirical results indicate that profits (scaled by the volume of business) and net interest margins were lower for domestic banks focused in this area. Domestic banks

with portfolios concentrated in areas that foreign banks did not enter forcefully (e.g. consumer lending) experienced little change in their profitability, net interest margins, or overheads (scaled by the volume of business). Dynamic effects, i.e. the effect of increased presence of foreign banks over the period in question and increased entry into particular sectors by foreign banks, are primarily analyzed in the context of mortgage and property lending. The results indicate that domestic banks focused in these areas experienced declining net margins, but increasing overheads (scaled by the volume of business). The leader-follower hypothesis had to be rejected.

Turning to cross-country studies, it is important to keep in mind that these studies provide conclusions that hold on average across a group of countries and thus cannot be considered as supportive evidence for any particular country.

In a pioneer study, **Claessens et al. (1998)** examine the extent of foreign ownership in national banking markets (a bank is defined to be foreign, if at least 50 percent of its shares are foreign-owned) and provide an empirical study of how foreign bank entry affects the operation of domestic banks, in both developed and developing countries, using bank-level and macroeconomic data for 80 countries, covering the period from 1988 to 1995. Efficiency comparisons between foreign and domestic banks reveal that the functioning of foreign relative to domestic banks is very different in developing and developed countries, with foreign banks achieving higher (lower) profitability and net interest margins than domestic banks in developing (developed) countries, implying that the reasons for foreign entry, as well as the competitive and regulatory conditions found abroad, differ significantly between developed and developing countries. The authors provide empirical evidence that a larger foreign ownership share of banks reduces profitability and overhead costs (scaled by the volume of business) of domestic banks, which suggests that foreign bank entry improves the functioning and efficiency of national banking markets, with positive welfare implications for banking

customers. Moreover, the number of entrants rather than their market share matters, which indicates that foreign banks affect local bank competition upon entry rather than after having gained substantial market share. Further, the authors find that foreign banks are attracted to markets with low taxes and high per capita income.

Using aggregate accounting data, **Terrell (1986)** compares the bank performance in fourteen OECD countries (eight of which permit foreign bank entry) for 1976 and 1977. He finds that banks chartered in countries that excluded foreign banks tended on balance to experience higher gross margins, higher pre-tax profits (scaled by the volume of business), and higher operating costs (scaled by the volume of business). Thus, banks in countries that excluded foreign bank entry appeared on balance to earn larger profits and to be less efficient. However, the author does not control for influences on domestic banking other than whether foreign banks are permitted to enter.

◆ The following two studies also focus on the impact of foreign bank entry on financial sector efficiency, but in addition they consider further implications.

Besides analyzing whether foreign banks improve the efficiency of domestic banks and eventually confirming the findings in Claessens et al. (1998), **Demirgüç-Kunt et al. (1998)** evaluate whether foreign banks increase the likelihood of suffering a banking crisis, and accelerate long-run economic growth. Using bank-level and macroeconomic data for 80 countries over the period 1988 to 1995, they find that foreign bank participation lowers the probability that a country will experience a banking crisis, and accelerates overall economic growth by boosting domestic banking efficiency. The authors also provide a descriptive case study on Korea, focusing on the relationship between foreign bank entry and the efficiency of Korean banks. They find that the particular case of Korea supports the conclusions of the cross-country analyses.

Claessens and Glaessner (1998) study the relationships between the openness of eight Asian financial markets[1] and institutional quality, financial sector fragility, and costs of financial services provision (banking services provision, securities markets, life-insurance services provision).[2] With respect to banking services provided, using data for the year 1995, the empirical results indicate that there exists a negative relationship between net margins and the share of foreign banks.[3] The authors also find a clear negative relationship between net margins and overhead (scaled by the volume of business) and the openness indicator for banking services. At the same time there is a positive relationship between profitability and foreign bank presence. The fact that increased foreign bank presence goes together with greater profitability and lower net margins suggests that openness encourages banks to reduce costs and diversify their income by relying to a greater extent on fee-based income. Furthermore, empirical evidence suggests that the limited openness to date has been costly not only in terms of higher costs of financial services, but also in terms of slower institutional development and more fragile financial systems.

◆ In contrast to the afore-mentioned studies, **Goldberg et al. (2000)** specifically focus on lending behaviour and examine patterns in local lending by foreign-owned (foreign-owned here reflects controlling interest, not necessarily implying majority share ownership) and domestic-owned banks in Mexico and Argentina to document the relative stability in lending by these banks to different client bases and to analyze the cyclical properties of such lending, using quarterly loan data for individual banks from 1994 through the middle of 1999. The empirical results indicate that in both, Mexico and Argentina, foreign banks exhibited higher loan growth rates compared to domestic-owned banks, with lower associated volatility, contributing to greater stability in overall lending. They find that foreign banks show notable credit growth during the crisis period in both countries. In Argentina, the loan portfolios of private foreign- and domestic-owned banks are similar, and lending rates respond similarly to economic signals (e.g. real GDP growth),

whereas in Mexico, foreign and domestic banks with lower impaired loan ratios have similar loan portfolios and responsiveness. State-owned banks in Argentina and banks with a high impaired loan ratio in Mexico have more stagnant loan growth and weak responsiveness. The authors conclude that bank health and not ownership per se was the critical element.

◆ In an early study, **Pigott (1986)** focuses on three basic issues concerning the impact of financial policy changes on foreign banks, namely (i) factors that have traditionally shaped host regulatory treatment of foreign banks, (ii) the potential impact of financial reform on this treatment, and (iii) the impact on foreign bank performance in the host country, and provides some aggregate statistics on the size and scope of foreign bank activities in selected Pacific Basin countries. The results suggest that financial reform may well bring liberalized treatment of foreign banks, but its impact on their aggregate performance is not clear-cut. Furthermore, he finds that while foreign banks rely more than domestic banks on foreign borrowing, foreign banks still fund between 70 and 80 percent of their domestic loans from domestic sources.

◆ A comprehensive review is offered by **Clarke et al. (2001)**, who summarize current knowledge on the issues (1) What draws foreign banks to a country, (2) Which banks expand abroad?, (3) What do foreign banks do once they arrive?, and (4) How does mode of entry (e.g. opening up a branch or a subsidiary) affect behaviour? and put forth an agenda for further study of the effects of foreign bank entry on developing countries. Concerning the first question, empirical research indicates that the degree of economic integration between a foreign bank's home country and the host country which it enters, the market opportunities available in the host country, and entry restrictions and other regulations (including tax treatment) have all affected the pattern and timing of foreign entry. With respect to the second question there is evidence indicating that bank size, efficiency, and home country restrictions are important determinants of which banks expand abroad. Regarding the

third question, the existing literature in the following three areas is reviewed: (i) the nature of competition with domestic banks, (ii) the implications of foreign entry for stability (e.g. concerns that foreign banks will drive domestic banks out of business, concerns related to credit crunches), and (iii) the behaviour of foreign banks (e.g. concerns that foreign banks will “cherry-pick“ the best available borrowers, while neglecting certain market segments). The initial indications with respect to the first area are that foreign entry does exert competitive pressure on all domestic banks, however, the pressures exerted are in specific lines of business. Current cross-country evidence regarding the second area indicates that foreign entry has provided on average net benefits in terms of stability. Studies on the net effect of foreign entry on access to credit for small and medium-sized enterprises have not been clear-cut, however, recent evidence suggests that access to credit is not severely diminished. Concerning the fourth question, potential implications of two modes of entry (de novo versus the acquisition of, or merger with, a domestic bank) as well as three organizational forms (branch, subsidiary, or representative office) are discussed. Regarding the latter, recent studies appear to indicate that subsidiaries allow foreign banks to offer a wider range of services and bring greater stability in lending to host countries.

While there are studies exploring the impact of financial liberalization in Thailand in general[4], no published country-case study exists to my knowledge that focuses on the quantitative impact of foreign bank entry on the Thai domestic commercial banking sector.