ISAS Brief

No. 111 – Date: 15 June 2009

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Foreign Bank Entry Reconsidered[1]

Ramkishen S. Rajan and Sasidaran Gopalan[2]

Until the mid-1990s, the banking systems in most of Asia remained heavily regulated, and barriers to foreign competition were prohibitively high. However, in the aftermath of the East Asian crisis of 1997-98, financial sector restructuring, including the revamp of the financial regulations, has been an important element in the structural adjustment programmes in Indonesia, Korea, Thailand and the Philippines. Broadly, governments in the crisis-hit regional economies have restructured their financial systems by shutting down commercial banks and finance companies, merging some existing institutions and nationalising others, injecting public funds to recapitalised viable banks, putting in place systematic asset resolution strategies, as well as easing regulatory impediments to foreign bank entry. Other countries in the region such as China and India have also taken steps towards financial deregulation.

This brief examines the economic motivations for and concerns with the introduction of greater foreign competition in the banking sector.

Economic Motivations behind Foreign Bank Entry

A commonly-held view is that the policy of banking-sector liberalisation, particularly with regard to easing restrictions on foreign bank entry, was imposed on the regional economies by the International Monetary Fund (IMF) and its largest shareholder as a condition of the 1997-98 bailouts. While this perception may be valid in some cases, it is instructive that even countries relatively unimpacted by the regional financial crisis such as China and India have been taking active steps to promote the internationalisation of their respective banking sectors. A proximate cause has been the World Trade Organization Agreement on Trade in Financial Services which requires gradual easing of restrictions on foreign banks.

However, independent of this, there has been a growing realisation among policymakers in Asia and elsewhere that a policy of easing barriers on foreign bank entry may be beneficial to the host countries. Certainly, one of most immediate motivations for undertaking this policy

---

[1] This brief is based on a forthcoming Working Paper by the authors.

[2] Ramkishen S. Rajan is a Visiting Senior Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore and an Associate Professor at George Mason University, Virginia, United States. He can be contacted at isasrsr@nus.edu.sg or rrajan1@gmu.edu. Sasidaran Gopalan is a Research Associate at the Institute of South Asian Studies. He can be contacted at isassg@nus.edu.sg.

in most of the crisis-hit countries was the much-needed funds that foreign investors would bring in to help recapitalise the banking systems. Beyond the financing issues, however, it is becoming increasingly apparent that foreign competition brings with it additional benefits that may not be likely in the case of domestic competition. For instance, there is a growing body of empirical evidence of the benefits of foreign bank entry in emerging economies by way of reductions in cost structures, improvements in operational efficiency, introduction and application of new technologies and banking products, marketing skills and management and corporate governance structures. In relation to this, foreign banks can enhance the quality of human capital in the domestic banking system by importing high-skilled personnel to work in the local host subsidiary as well as via knowledge spillovers to local employees. Customers ought also to benefit in terms of being able to access new financial services. Bank internationalisation may also create domestic pressures for local banking authorities in the host countries to enhance and eventually harmonise regulatory and supervisory procedures and standards, and the overall financial infrastructure to international best practice levels.

The opening up of the domestic banking sector to foreign participation might also encourage some of the local banks to venture overseas to compensate for the loss of domestic revenue sources or more generally because they have learnt from the experiences of their foreign competitors who have entered the local market. Thus, as Singapore’s domestic banking system has become more internationalised since 1997-98, existing local banks in Singapore have both consolidated their domestic operations and also aggressively expanded their operations overseas and have been active participants in cross-border mergers and acquisitions. Singaporean banks, for instance, have purchased significant stakes in banks in India, Indonesia, Hong Kong, Thailand and the Philippines, just to name a few. Similarly, India’s largest bank, the State Bank of India, has been aggressively establishing ventures overseas in recent years just as the domestic market in India has become somewhat more open to domestic private and foreign banks.

Foreign Bank Entry: Source of Stability or Contagion?

Available data on bank assets, loans, deposits and the like offers some indicative evidence that the liberalisation of entry norms for foreign banks has borne fruit in terms of increased penetration of domestic markets in Asia by foreign banks, particularly in the cases of Indonesia and South Korea. However, it is striking that most of Asia continues to lag behind other emerging markets in Central or Eastern Europe and Latin America The relatively low penetration of banks into Asia is consistent with the fact that while Asian economies have been deregulating their banking systems for reasons noted above, they have approached this process more cautiously than their counterparts in East Europe or Latin America. Apart from parochial protectionist arguments, there are actually some valid concerns with the internationalisation of the banking sector that need to be addressed.

For some time, the conventional wisdom has been that a banking system with an internationally diversified asset base may be more likely to be stable and less crisis-prone. There is evidence, for instance, that the foreign bank branches have lower non-performing loan ratios than domestic banks in Korea, Malaysia and Thailand. In addition, the domestic branches of foreign banks may be able to obtain financing from the foreign head office which could act as a private lender of last resort during a period of financial stress. Conversely, however, there are are rising anxieties in some quarters that foreign banks might be a source of instability and contagion rather than stability. This appears to have been the case in the recent global financial crisis which hit the Eastern European financial system much harder

than it has the relatively more closed and regulated Asian financial system. Does foreign bank entry, or more broadly, the internationalisation of the financial sector, make the country prone to international capital booms and reversals?

Many casual observers of financial liberalisation fail to make a distinction between "capital account deregulation" (such an external borrowing) on the one hand and "internationalisation of the financial sector" on the other. The latter is broadly defined as the elimination of barriers to entry and discriminatory treatment of foreign competition and cross-border provision of financial services. The General Agreement on Trade in Services recognises the right of countries to maintain sovereignty over prudential and related regulations of all financial firms resident in the country, including capital account controls. It is more likely that capital account openess in the form of cross-border bank lending makes a country relatively more crisis-prone than when a foreign bank establishes a separate entity in the host country and lends domestically, especially if the mode of entry by the bank is in the form of a fully independent subsidiary (as opposed to a branch or representative office).[3] One would also expect that domestic lending via an onshore foreign bank would more likely be in domestic currency, while offshore lending would be in foreign currency (such as the United States dollar), hence leaving the country more vulnerable to currency mismatches and financial crisis (that is, negative balance sheet effects).

Beyond this, the other broad economic justifications for continued protection of the domestic banking system boil down to the usual "infant industry" and "strategic" industry arguments. The first essentially argues that time is needed for domestic bank consolidation if local banks are to compete effectively against foreign multinational banks which have much larger and more diversified capital bases. The second maintains that the financial sector, with its intricate linkages to the rest of the economy, is "too important to be left in the hands of foreigners". While the infant industry argument has merit in theory, as is usually the case, the problem in practice is that most infants take too long to grow up and, many a times, they grow old rather than grow up. The other problem with infant industries is that they often form a dependency on the state to protect them from threats and consequently tend to become fairly inefficient and it is usually the consumer who usually loses out at the end. With regard to the strategic industry argument, one could turn it on its head and suggest that, in view of the importance of the banking and overall financial sector to the rest of the economy and society, everything possible must be done to ensure it is as efficient as possible, and that includes welcoming foreign bank participation. In any event, as with most other industries, the infant and strategic industry arguments appear more valid as grounds for moderating the pace and possibly even the extent of foreign bank entry, rather than opposing the policy in its entirety.

However, one outstanding concern of deregulating the domestic banking system that has gained greater credence recently is that it could weaken the ability of the central bank to use "moral suasion" in times of a crisis. For instance, the ongoing financial crisis has made apparent the lack of effectiveness of conventional monetary policy, due in part to the fact that liquidity infusions by many central banks into the domestic financial system have remained clogged up without being passed on to the real economy in terms of bank lending (hence resulting in a sharp decline in the money multiplier). However, this has been somewhat less

---

[3] This said, much more research is needed on the relative costs and benefits of branches versus subsidiaries, the latter being relatively independent from the parent. For instance, are the former more likely to be supported by their parent in the event of a crisis in the host country but also more likely to "cut-and-run" in the event of a crisis in the source country or a global crisis?

of a problem is some Asian economies such as India and China with large public sector dominated banks (de facto or de jure) as the central banks in these countries have been able to “cajole” the domestic commercial banks to lower lending rates and increase lending to the private sector. There is also a belief in some quarters that large foreign multinational banks can be difficult to supervise given their complex structures.

The quasi-nationalisation of some major financial institutions in the United States has only fuelled concerns in parts of Asia and elsewhere on allowing unmitigated denationalisation of the banking system of any kind, particularly foreign bank entry. In view of this, it is likely that Asian economies will take steps to ensure that the domestic financial institutions continue to play a crucial role in the financial system. However, it should be reiterated that as long as the internationalisation of the banking sector is properly managed, fears that no domestic financial institutions may survive following foreign bank entry are exaggerated. Indeed, cross-country evidence suggests that the first-mover and informational or familiarity advantages enjoyed by domestic banks for some business often limits the extent of inroads that foreign banks can make, at least in the short run. This said, it is important to ensure that foreign investments do not largely originate from a single source country as this might actually increase rather than decrease instability.

oooOOOooo