The role of foreign banks in post-crisis Asia: the importance of method of entry

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The Importance of Method of Entry

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PREFACE

The ADB Institute aims to explore the most appropriate development paradigms for Asia composed of well-balanced combinations of the roles of markets, institutions, and governments in the post-crisis period.

Under this broad research project on development paradigms, the ADB Institute Research Paper Series will contribute to disseminating works-in-progress as a building block of the project and will invite comments and questions.

I trust that this series will provoke constructive discussions among policymakers as well as researchers about where Asian economies should go from the last crisis and recovery.

Masaru Yoshitomi
Dean
ADB Institute
ABSTRACT

This study examines the role of foreign banks in post-crisis Asia, focusing particularly on the four countries most affected by the Asian Crisis of 1997—Indonesia, Korea, Malaysia and Thailand.

First, using data on the presence of foreign banks via branching as well as subsidiaries, the study shows that the presence of foreign banks in the four crisis-hit countries is actually much larger than has been previously reported once the presence of foreign branches is accounted for in the data. However, the percentage of assets controlled by foreign banks in Asia is still lower than that of other emerging economies, despite great increases in the post-crisis period. The author reviews regulations on foreign bank entry that may have limited the presence of foreign banks or influenced the method of entry (branching versus subsidiary).

Given recent regulatory changes and the need for bank recapitalization in the region, the presence of foreign banks is expected to increase in the near future, so this study next takes up the policy implications of this trend. To date, foreign banks in most Asian countries appear to perform relatively worse than their domestic counterparts as measured by return on equity, cost to income ratios, and the ratio of problem loans to total loans. This finding contradicts previous research in other emerging economies, and may be due to the fact that foreign bank entry in Asia is still a very recent phenomenon, and has occurred mostly through the takeover of troubled banks in the region.

The second policy issue examined here is the stability of lending by foreign banks relative to domestic banks. Macroeconomic data suggests that foreign bank lending may in some cases be more stable than domestic bank lending, particularly during crisis, but that the stability of foreign bank lending varies greatly by method of entry. Cross border claims of foreign banks are the most volatile, followed by foreign bank branch lending. Lending by foreign bank subsidiaries capitalized in the host country appear to be more stable than domestic lending, perhaps providing much needed capital during times of crisis.

Therefore, foreign banks play an important role in Asia, not only in the traditional ways by providing new services and stimulating competition and efficiency, but also by contributing to stability of the banking sector in the face of macroeconomic fluctuations. However, the mode of foreign entry seems to have important implications for the contributions of foreign banks. Since lending by off-shore banks and foreign bank branches seems to be more volatile than locally capitalized foreign subsidiaries, policy makers in Asia should encourage foreign players to enter via fully-owned subsidiaries or joint ventures and move away from the previous pattern of branch-based entry.
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The Role of Foreign Banks in Post-Crisis Asia: 
The Importance of Method of Entry 
Heather Montgomery

1. Introduction

Although the Asian Crisis has brought consensus on the necessity of strong domestic financial systems, there is less consensus on the role of foreign banks in achieving the goals of economic growth and stabilization. Foreign banks are one obvious source for the capital so badly needed in the region, and proponents of their entry argue that foreign participation is a vital part of creating a vibrant financial system with a wide range of financial services and industries (Liu (2002b)). But policy makers in the region worry about the potential negative effects of opening up their financial markets to foreign participation. Recent research showing a pattern in which financial crises tend to be preceded by financial liberalization has increased concern about the effects of opening up the banking system. In particular, there are concerns that foreign bank entry will expedite “de facto KAO (capital account opening)” (Liu (2002a)), perhaps contributing to the instability of financial markets and the banking sector.

This study on the role of foreign banks in post-crisis Asia begins, in section 2, by providing some quantitative estimates of how far foreign banks have penetrated the banking sector in Asia and other emerging markets. Previous studies have underestimated the presence of foreign banks in Asia due to their failure to account for entry via branching, the mode of entry most common in Asian countries. Section 3 discusses this point, as well as the advantages and disadvantages of entry via branching versus merger and acquisition. However, even after accounting for entry via branching, the level of participation of foreign institutions in Asia is still much lower than that in other emerging market economies in Latin America and Central and Eastern Europe. Section 4 discusses the regulations on foreign entry in Asian countries, which have contributed to this state of affairs, and how these regulations have changed in the aftermath of the Asian Crisis. As a result of these regulatory changes, the participation of foreign banks in Asia is expected to increase in coming years. Section 5 discusses the expected effects of increased foreign participation on domestic institutions in Asia and on the banking sector as a whole. It reviews the theoretical arguments for and against foreign bank participation in emerging markets and surveys the empirical evidence available on the issues of efficiency, competition and stability. Finally, section 6 concludes.
2. Penetration of Foreign Banks in Asia

Table 1. Penetration of Foreign Banks in Emerging Economies

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<tbody>
<tr>
<td><strong>Central Europe</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>46.6</td>
<td>5.8%</td>
<td>63.4</td>
<td>49.3%</td>
</tr>
<tr>
<td>Hungary</td>
<td>26.8</td>
<td>19.8%</td>
<td>32.6</td>
<td>56.6%</td>
</tr>
<tr>
<td>Poland</td>
<td>39.4</td>
<td>2.1%</td>
<td>91.1</td>
<td>52.8%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>112.8</strong></td>
<td><strong>7.8%</strong></td>
<td><strong>187.1</strong></td>
<td><strong>52.3%</strong></td>
</tr>
<tr>
<td><strong>Latin America</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>73.2</td>
<td>17.9%</td>
<td>157</td>
<td>48.6%</td>
</tr>
<tr>
<td>Brazil</td>
<td>487</td>
<td>8.4%</td>
<td>732.3</td>
<td>16.8%</td>
</tr>
<tr>
<td>Chile</td>
<td>41.4</td>
<td>16.3%</td>
<td>112.3</td>
<td>53.6%</td>
</tr>
<tr>
<td>Colombia</td>
<td>28.3</td>
<td>6.2%</td>
<td>45.3</td>
<td>17.8%</td>
</tr>
<tr>
<td>Mexico</td>
<td>210.2</td>
<td>1.0%</td>
<td>204.5</td>
<td>18.8%</td>
</tr>
<tr>
<td>Peru</td>
<td>12.3</td>
<td>6.7%</td>
<td>26.3</td>
<td>33.4%</td>
</tr>
<tr>
<td>Venezuela</td>
<td>16.3</td>
<td>0.3%</td>
<td>24.7</td>
<td>41.9%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>868.6</strong></td>
<td><strong>7.5%</strong></td>
<td><strong>1302.4</strong></td>
<td><strong>25.0%</strong></td>
</tr>
<tr>
<td><strong>Total excluding Brazil and Mexico</strong></td>
<td><strong>171.4</strong></td>
<td><strong>13.1%</strong></td>
<td><strong>365.6</strong></td>
<td><strong>44.8%</strong></td>
</tr>
<tr>
<td>Asia</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Indonesia</td>
<td>n.a.</td>
<td>n.a.</td>
<td>43.6</td>
<td>6.7%</td>
</tr>
<tr>
<td>Korea</td>
<td>638</td>
<td>0.8%</td>
<td>642.4</td>
<td>4.3%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>149.7</td>
<td>6.8%</td>
<td>220.6</td>
<td>11.5%</td>
</tr>
<tr>
<td>Thailand</td>
<td>192.8</td>
<td>0.5%</td>
<td>198.8</td>
<td>5.6%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1091</strong></td>
<td><strong>2.8%</strong></td>
<td><strong>2004.2</strong></td>
<td><strong>6.3%</strong></td>
</tr>
</tbody>
</table>

* In billions of U.S. dollars. As of December

The presence of foreign banks in emerging markets has increased dramatically in the 1990s, but this increase has not been as rapid in Asia as it has in the emerging markets of Central and Eastern Europe or Latin America. Figure 1, from Mathieson and Roldos (2001), shows the percent of assets under foreign control¹ in several emerging markets.

¹ Mathieson and Roldos (2001) use three different measures of foreign bank participation in emerging markets: “Foreign Participation” is measured as the ratio of the sum across all banks of the assets of each bank multiplied by the percentage of equity held by foreigners to total bank assets. However, since corporate control may not be directly and exclusively related to the proportion of a bank’s equity held by a particular owner, “Foreign Control” measures the ratio of the sum of the total assets of those banks where foreigners own more than either 40 or 50 percent (Although holding more than 50% of total equity
markets. By this measure, participation in Asia is well below that of emerging markets in Central Europe and Latin America.

Central Europe displays the largest growth in foreign participation, with the share of foreign control increasing from less than 10 percent to over 50 percent between 1994 and 1999. Foreign participation in the banking sector there was prompted by the privatization of the previously state-owned banking system. Hungary was the first to embark on an aggressive privatization plan, and by the end of 1999 foreign participation in the banking sector reached about 60% of total assets. Poland’s privatization drive has accelerated in the past two years and the share of foreign control of bank assets is now above 50%. The Czech Republic began to privatize its state-owned banks in 1998, and by the end of 1999 foreign institutions controlled almost 50% of total bank assets. That percentage is expected to reach more than 90% with the privatization of the last remaining large state-owned bank in 2001 (Mathieson and Roldos (2001)).

Likewise, in Latin America, where foreign banks have had a presence for decades, foreign control of total bank assets increased from under 10% in 1994 to over a quarter of the banking sectors total assets in 1999. The presence of foreign banks is especially strong in Argentina, Chile and Mexico. They already had a substantial participation rate in Argentina and Chile in 1994, and by 1999, the percentage of bank assets under their control had increased to roughly half. The increase in foreign control in Mexico, from less than 1% in 1994 to 19% in 1999 is even more striking. The sale of the third largest Mexican bank in May 2000 and the second largest one in June 2000 will bring foreign control to about 40% (Mathieson and Roldos (2001)). According to them, Brazil is the only market in Latin America where foreign banks are unlikely to dominate, due to the large share of bank assets under government control and the presence of three well-capitalized, well-managed private banks.

Among the emerging economies, Asia stands out in terms of the lack of a foreign presence in its banking sector. Although foreign participation in the sector has increased dramatically since the Asian crisis of 1997, according to Mathieson and Roldos (2001), the percentage of assets under majority foreign control in Asia still remained only 6% in 1999.

3. Method of Entry

Most studies of foreign participation in the banking sector in Asia underestimate the presence of foreign banks, since they focus on the percentage of assets controlled by fully-owned, locally-capitalized foreign bank subsidiaries or joint ventures in which a foreign partner owns a majority share, and ignore the more significant presence of foreign banks via branching. Until very recently, foreign commercial bank operations in Asia were conducted almost entirely through branches or representative offices rather than wholly-owned subsidiaries or joint ventures (Pigott (1986)).

typically ensures effective control of a bank, according to Mathieson and Roldos (2001), a number of analysts have argued that hostile takeovers are unlikely to occur when the existing owners hold more than 40% of bank equity. The data reported in figure 1 correspond to the 50% foreign control measure. Total Assets are measured in billions of US dollars.

2 This generalization does not apply to all Asian countries. In Malaysia, for example, almost all foreign bank participation occurs through majority foreign-owned joint ventures or fully foreign-owned subsidiaries.
This tendency to enter via branching is largely the result of regulatory policies in Asia as discussed below, but it may also be a strategic choice by the foreign banks. For example, ABN-Amro, Commerzbank, HSBC and Banco Santander, which has a heavy presence in Latin America, have tended to enter foreign markets by purchasing a minority or majority interest in an existing domestic franchise. On the other hand, Citibank, Chase-JP Morgan and Deutsche Bank have tended to enter via branching or fully-owned subsidiaries, giving them more control over the newly established bank and the opportunity to grow “organically” in the new market (Pomerleau and Vojta (2001)).

Parkhe and Miller (1998) define overseas subsidiaries and overseas branches of foreign banks as follows. Overseas subsidiaries of foreign banks are legal entities separate from their “parent” bank and are subject to the laws and regulations of the host country. They also may provide the means to isolate the parent and other branches from host country laws. Lending must be based on the subsidiaries’ own capital, so subsidiaries almost always require higher capitalization than branches of the same size. The offices resemble host country banks and typically adopt a local character with local management to obtain access to the local business market.

Overseas branches, on the other hand, are “integral parts of foreign parent bank organizations” (according to the U.S. Department of Commerce). Thus, branches are subject to taxes and laws of the home country, and their financial policies are mandated by the parent bank. Lending limits for overseas branches are based upon the worldwide capital of the parent bank. Branches can perform traditional banking functions such as accepting deposits and issuing loans, but “foreign bank branch activities tend to be largely wholesale in nature trade with financing and lending to relatively large corporations and government agencies generally accounting for the major share of assets” (Pigott (1986)).

The advantages of branching over having a fully foreign owned subsidiary include securing the full credit backing of the parent bank, attracting clients through the parent’s reputation and access to the managerial and technical support of the parent bank. Subsidiaries tend to be the preferred form of entry for international banks, since unlike branches, they can provide a broad array of financial services (Parkhe and Miller (1998)). From the perspective of the host country, branches of foreign banks have their own lender of last resort, the foreign head office or home country monetary authority. This effectively reduces the burden on the host country in supplying liquidity. Fully-owned subsidiaries may provide some of the same advantages. For example, although local subsidiaries of international banks are technically locally capitalized and therefore independent, it is argued that reputational effects will prevent the parent from allowing the subsidiary to fail.

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3 In the United States, 80% of the total assets of foreign owned banks in 1990 were accounted for by overseas branches (Hasegawa 1993).

4 It is difficult to classify banks as engaging in the “retail” or “wholesale” business, since most banks conduct a combination of both. But in general, overseas subsidiaries tend to have more retail business while branches of foreign banks tend to stay in wholesale banking.
Using data including foreign bank branching, we find that foreign banks hold a significantly larger share of total assets in Asia than indicated by previous studies. As shown in Table 2, the penetration of foreign banks in Asian countries varies significantly by country, but is significantly higher than the 6% indicated in Table 1, which only included fully foreign-owned subsidiaries. For example, in Korea, where almost no bank assets are under foreign control (with more than 50% foreign ownership), foreign banks including branches accounted for over 7% of total banking sector assets in 2000. In Indonesia, Malaysia\(^5\) and Thailand as well, the inclusion of data on foreign bank branches more than doubles the reported percentage of assets under foreign control.

However, even after accounting for the significant amount of foreign bank participation occurring through branching, it is clear that the penetration of foreign banks in Asia is still much lower than in Central Europe or Latin America. Even in Malaysia, where foreign banks hold more than 24% of total banking sector assets, the percentage is lower than in Central Europe or in Latin America. Overall, the participation rate of foreign banks in Asia is currently below the level of Central Europe or in Latin America even in the early 1990s.

### 4. Regulations on Foreign Bank Entry in Asia

The low participation rate of foreign banks in Asia is largely a legacy of strict regulation on foreign bank entry and operation by governments in Asia. Until fairly recently, most Asian countries had formal restrictions on the entry of foreign bank branches, in most cases explicit bans. Even in countries where the new entry of foreign banks was legally permitted, it was prevented in practice (Pigott (1986)). The same is true of entry via minority interest or joint venture banks. For example, even before the 1997 crisis, foreign bank subsidiaries in Korea were “permitted in principle but prevented in practice by host authorities’ unwillingness to expand the number of domestically chartered banks”. The exception was KORAM bank, a joint venture of Bank of America and local Korean banks. It has now been joined by Korea First Bank, which is majority owned by the foreign Newbridge Capital.

Formal and informal restrictions on not only entry, but also operations, of foreign banks were also common. With the exception of Malaysia, until very recently

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\(^5\) In Malaysia, where all foreign bank participation takes the form of fully owned foreign subsidiaries, the increase in foreign participation rates in Table 2 is accounted for by the fact that banks not listed on the local stock market are also included in the data set.
no country in Asia afforded foreign banks “national treatment”, meaning the same powers and restrictions as domestic banks (Pigott (1986)). In almost all countries government deposits were limited to domestic banks and foreign banks were denied access to the central bank discount window and subsidized trade credit facilities. In Korea, although foreign banks could “by and large participate in essentially the same range of commercial lending activities, and on essentially the same terms, as their local competitors”, in practice they were generally limited to one or two branch offices, nearly always in the main financial centers. This seriously limited their ability to gather local currency deposits from other regions. In addition, regulations governing foreign branch capital effectively limited the funds they could obtain on the interbank market, as well as the total amount of deposits they could accept. In Indonesia, they were prohibited from taking time deposits and were geographically restricted in their lending activity as well, to the Jakarta region.

However, in other areas, particularly those involving foreign currency transactions, foreign banks had advantages over their domestic competitors. For example, in Korea, “foreign banks were permitted to ‘swap’ foreign exchange for lending in won at a guaranteed margin, a privilege not granted to domestic banks”. Even when overt discriminatory policies were not in place, domestic banks were sometime to subject to government credit allocation programs not imposed on foreign banks. For example, state-owned or controlled banks in Indonesia and Korea have been subject to requirements that they allocate a certain portion of credit to key sectors, often at preferential rates.

4.1. Indonesia

Foreign banks were effectively expelled from Indonesia by the Sukarno regime in the 1950s, only to be brought back in 1968 as the Suharto government sought to revive the country’s banking system. However, after an initial influx of eleven foreign banks that year, a ban on new entry was imposed in 1969 (Pigott (1986)), (Nasution (1983)). However, several joint venture banks were established following the 1988 PAKTO reforms, which opened up the banking sector to new entrants. Under these reforms, foreign banks were allowed to set up joint ventures with domestic banking partners, but they were restricted to 2 offices in each of 6 cities. Although there are no longer any restrictions on the number of branches permitted to foreign banks, they are still required to have half of their loan assets available for export-related lending.

Before the Asian crisis, it was considered unlikely that more foreign banking licenses would be granted, but that may have changed (Asian Capital Markets Online Handbook). One very evident result of the crisis is that the percentage of foreign ownership in joint ventures is now very high. With the collapse of the banking sector and the overall economy in 1997, joint venture banks suffered massive losses. In many cases, the domestic partner was unable to participate in the recapitalization of the bank. In response, the government raised the limit on the foreign ownership of joint-venture banks from 85% to 99% and now the percentage of foreign ownership in Indonesia’s

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6 Domestic banks were generally also limited in the number of branches they could have, but since they usually pre-dated the foreign banks, they usually had substantial nationwide branch networks.
“joint banks” is very high. There are also many foreign banks operating in Indonesia as branches of their parent bank.

4.2. Korea

Foreign banks in Korea faced several restrictions on their operations, as well as some special discriminatory treatment, but these were lifted in the early 1990s as Korea moved toward the “national treatment” of foreign banks. Restrictions on the number of branches they were allowed to operate were abolished in the mid-1980s (Park (1996)) and foreign ownership through joint ventures or fully-owned subsidiaries was completely liberalized after the 1997 crisis (Cho (2002)). Although the majority stock purchase in Korea First Bank by Newbridge Capital in December 1999 significantly raised the amount of bank assets under foreign control in Korea, almost all foreign entry into the banking sector there is still through foreign bank branches rather than joint ventures.

4.3. Malaysia

Compared to other Asian countries, Malaysia has a relatively large presence of foreign banks. But authorities in Malaysia at first exhibited caution in opening up the sector. Originally, foreign banks could only make loans in partnership with domestic banks, and the foreign ownership of joint venture banks was limited to 30%. After 1983, roughly one decade passed in which no new foreign banks were established. However, between 1995 and 1996, several 100% foreign owned banks were established. Now, many foreign banks are operating in Malaysia, and their role in Malaysia’s banking sector is similar to that of Indonesia, where there are many locally capitalized foreign banks. Of the 27 commercial banks, half are locally incorporated, fully foreign-owned subsidiaries and one is a joint venture with a foreign bank holding a substantial minority share. Most of these foreign subsidiaries have been operating since 1994 because under the Banking and Financial Institutions Act of 1989, all foreign banks were required to be incorporated locally by the end of September 1994.

4.4. Thailand

Foreign bank branches were established early in Thailand; in fact commercial banking began in 1888 with a foreign bank branch. At first, foreign bank branches were the most active banks, but government restrictions restricted their growth. “Before the financial crisis emerged—no new banking license had been issued for more than twenty years. Furthermore, —almost all foreign banks were allowed to operate only one branch in Bangkok” (Santiprabhob (2002)). Locally incorporated banks were required by law to be majority owned by Thai citizens, so there was no foreign entry via joint ventures or foreign-owned subsidiaries.

This changed with the financial crisis of 1997. It left banks in need of large amounts of new capital which could not be raised in local markets. In response, the government relaxed foreign ownership restrictions, allowing foreign interests to hold a majority stake in Thai financial institutions for up to ten years. As a result, at the end of
2001 there were four majority foreign-owned joint venture banks operating there. There have also been several new foreign entrants into the banking sector via branching in the post-crisis period, but there are no 100% foreign-owned subsidiaries of foreign banks listed on the Thai Stock Exchange.

5. Effects of Foreign Bank Entry

As documented in Section 4, the presence of foreign financial institutions in Asia is likely to increase rapidly in the coming years due to regulatory changes enacted in the wake of the crisis of 1997. Given the trends observed in the rest of the developing world, it is expected that the role of foreign banks will increase in the near future. This topic has been a focus of debate by policymakers in these countries as well as academics studying the issue.

In support of increased participation, many point out that foreign banks can play an important role in facilitating capital inflows, thus enhancing the host country’s access to international capital. Their presence may improve the financial infrastructure, including accounting and transparency, by stimulating the establishment and strengthening of rating agencies, auditors, credit bureaus and the development of the host country’s supervisory and legal framework. In addition, they effectively “import” financial system supervision and supervisory skills from home country regulators, which may spill over to the host country (Levine (1996), Liu (2002a), Liu (2002b)).

There are also arguments against foreign bank participation. Policymakers worry about competition from them. Foreign banks may be able to “cherry pick” the “best” customers, leaving domestic banks to serve the remaining high risk customers. Proponents of entry defend their position by arguing that competition will spur domestic banks to improve quality and cut costs, thus promoting financial development. Others claim that fears that foreign banks will dominate the entire market are unsubstantiated, since they enter countries by targeting specific market niches.

In the wake of the Asian crisis of 1997, there are also concerns that foreign banks have a destabilizing effect because they provide additional avenues for capital flight and may rapidly withdraw in the face of a crisis (Park (2002)). However, proponents of their entry point out that since domestic branches of foreign banks are likely to possess a more internationally diversified asset base, they may be less vulnerable to domestic business cycles, and thus may provide a more stable source of credit than domestic banks.

However, as noted by Suehiro (2002), we should not over-emphasize the presence of foreign banks in Thailand since “the top five local commercial banks have never changed their ultimate owners even after the crisis, and they still control 75% of total assets and deposits among the thirteen existing local commercial banks”.

In their study of Argentina, Canada and Mexico, Gruben and Moore (1999) find that the link between financial liberalization or privatization and risky behavior on the part of banks depends upon the degree of market discipline. In their study, in countries without market discipline, lending risk increased significantly in the wake of financial liberalization, but in countries where depositors disciplined banks, banks did not behave risky and risk did not increase in the wake of privatization. Peria and Serio (2001) find evidence of the existence of market discipline in Argentina, Chile and Mexico during the 1980s and 1990s: depositors punished risky banks by withdrawing their deposits. The authors conclude that “across countries and across deposit insurance schemes, market discipline exists even among small, insured depositors.”
This section examines each of these last two arguments in turn: the amount of competition from foreign entrants and the effects of this competition on the efficiency of the host country’s banking sector as a whole; and the effects of foreign entry on the stability of the host country’s banking system.

5.1. Competition and Efficiency

There are several issues related to competition and efficiency that need to be considered by policymakers. First, are foreign banks more or less efficient than domestic banks operating in the host country? If, as many proponents of entry suppose, they are more efficient than domestic banks, then what effect will their entry have on domestic banks already operating in the host country? Will the competition spur efficiency gains among domestic banks as well, promoting financial development in the host country? Or will the foreign banks simply outcompete the domestic banks, taking over the entire banking sector?

Many early studies on foreign bank entry, which focused on industrialized countries, found that foreign banks there tended to be less efficient than domestic banks (Chang, Hasan and Hunter (1998), DeYoung and Nolle (1996), Hasan and Hunter (1996), Mahajan, Rangan and Zardkoohi (1996), Peek, Rosengren and Kasirye (1998)). A cross-country study investigating the efficiency of foreign banks in the mature markets of France, Germany, Spain, the United Kingdom and the United States, confirmed this view, with the finding that foreign entrants are less efficient in terms of profits and costs than domestic banks (Berger et. al. (2000)). In the case of foreign entry via the takeover of an existing bank, it is possible that the poor performance is due to problems that were already present at the time of acquisition. But research has shown that even after changes in business strategy by the new foreign owners, the performance of the banks did not improve (Peek, Rosengren and Kasirye (1998)).

By contrast, studies on the effects of foreign bank entry in developing countries report the opposite findings. There, foreign banks appear to be more efficient than domestic banks (Barajas, Steiner and Salazar (1999), Clarke et. al. (1999), Clarke et. al. (2001), Demirgüc-Kunt, Levine and Min (1998), Denizer (1999), Honohan (2000), Kiraly et. al. (2000)). Even in the case of entry via the takeover of an existing domestic bank, research shows that in emerging markets in Latin America, the financial strength ratings of local banks acquired by foreign entities generally improve relative to their domestic counterparts (Crystal, Dages and Goldberg (2001)). Not only do foreign banks in emerging markets tend to be more efficient than domestic banks, but significant entry is associated with increases in the efficiency of domestic banks as well. These efficiency effects were shown to occur immediately after entry and did not depend upon the foreign banks gaining a substantial market share (Claessens and Glaessner (1999), Demirgüc-Kunt, Levine and Min (1998)).
Table 3. Performance of Foreign and Domestic Banks in Emerging Economies

<table>
<thead>
<tr>
<th></th>
<th>Return on Equity</th>
<th>Cost-to-Income ratio</th>
<th>Problem loans/ total loans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(units: %)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>Domestic Banks</td>
<td>Foreign Banks</td>
<td>Domestic Banks</td>
</tr>
<tr>
<td>Central Europe</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>14.4</td>
<td>70.9</td>
<td>18.8</td>
</tr>
<tr>
<td>Hungary</td>
<td>16.1</td>
<td>62.4</td>
<td>10.6</td>
</tr>
<tr>
<td>Poland</td>
<td>24.1</td>
<td>50.9</td>
<td>11.1</td>
</tr>
<tr>
<td>Total</td>
<td>19.3</td>
<td>59.9</td>
<td>13.7</td>
</tr>
<tr>
<td>Turkey</td>
<td>68.3</td>
<td>39</td>
<td>6.1</td>
</tr>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>5.8</td>
<td>73.4</td>
<td>5.7</td>
</tr>
<tr>
<td>Brazil</td>
<td>10.4</td>
<td>73.3</td>
<td>7.5</td>
</tr>
<tr>
<td>Chile</td>
<td>10.9</td>
<td>59.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Colombia</td>
<td>2.7</td>
<td>70.6</td>
<td>5.4</td>
</tr>
<tr>
<td>Mexico</td>
<td>-14.3</td>
<td>112.3</td>
<td>4.1</td>
</tr>
<tr>
<td>Peru</td>
<td>14.9</td>
<td>64.8</td>
<td>6</td>
</tr>
<tr>
<td>Venezuela</td>
<td>40.6</td>
<td>56.3</td>
<td>3.9</td>
</tr>
<tr>
<td>Total</td>
<td>6.3</td>
<td>77.9</td>
<td>6.1</td>
</tr>
<tr>
<td>Total excluding Brazil and Mexico</td>
<td>9.9</td>
<td>67.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Asia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>-44.2</td>
<td>53.7</td>
<td>15.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>16.4</td>
<td>34.7</td>
<td>6.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>-66.1</td>
<td>128.9</td>
<td>46.2</td>
</tr>
<tr>
<td>Total</td>
<td>-35.7</td>
<td>63.8</td>
<td>19.2</td>
</tr>
</tbody>
</table>

In Asian economies, because the entry of foreign banks is still a relatively new phenomenon, there are only limited empirical studies of the relative performance of foreign and domestic banks. Table 3 from Mathieson and Roldos (2001) shows that in the emerging economies of Central and Eastern Europe and Latin America, foreign banks generally report higher returns on equity and lower cost-to-income and problem loan ratios than do domestic banks. However, in some Asian countries, the performance indicators of locally-capitalized foreign banks are worse than those of domestically-owned banks. This may be due to the fact that it was only recently that many foreign
banks entered Asia via mergers and acquisitions. These few takeovers and mergers were often allowed only in order to provide much needed capital to troubled banks in the aftermath of the Asian crisis. In time, these newly acquired banks may regain their asset quality and performance. Note that in Malaysia, where foreign owned subsidiaries pre-date the Asian crisis of 1997, foreign banks outperform domestic banks on aggregate.

Studies which look at measures of openness to foreign entry rather than actual entry by foreign banks suggest that the limited openness of Asian economies to date has been costly. Cross-country studies find that tighter restrictions on entry into the banking sector tend to increase overhead costs and reduce the efficiency of the banking sector (Barth, Caprio and Levine (2001)). A related study of eight Asian economies in particular reveals that “the costs of financial services and the fragility of the financial systems are negatively related to the degree of openness of the domestic market to foreign financial firms” (Claessens and Glaessner (1999)).

Even if foreign banks prove to be more efficient than domestic banks in Asia, as they have been in other emerging markets, fears that they will take over the entire banking sector and completely dominate domestic banks are probably unrealistic, since they enter countries by targeting specific market niches (Levine (1996)). A study of the effect of foreign bank entry on domestic banks in Argentina shows that they tend to enter specific areas where they have a comparative advantage. Although domestic banks with a concentration in areas that were aggressively targeted by foreign banks experienced falling net margins and increasing overheads, domestic banks specializing in other markets showed higher net margins and higher before tax profits (Clarke et. al. (1999)). Thus, even if Asia opens to foreign bank entry, domestic banks will be able to retain competitive advantages that come from “superior knowledge of local circumstances and relationships within the local community” (Meltzer (1998)).

The degree of competition felt by domestic banks upon foreign entry depends to some extent upon the reason for the entry into the host market. Many studies examining the determinants of foreign bank activity find that the expansion is determined by foreign direct investment in other sectors of the economy, suggesting a “follow the customer” strategy (Aliber (1984), Buch and Lapp (1998), Buch (2000), Goldberg and Saunders (1981), Goldberg and Johnson (1990), Gross and Goldberg (1991), Miller and Parkhe (1998), Sabi (1988), Sagari (1992)). However, most of these studies focus on U.S. banks, and the motivation behind their entry into foreign markets, varies by region. In Latin America, the first wave of foreign bank entry came as a result of regulatory liberalization, and accelerated in the wake of the Tequila Crisis. In Central and Eastern Europe, foreign bank entry came after government-owned banks were privatized. In Asia, it seems to follow foreign direct investment in other sectors.

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9 Clarke et al. (2001) point out that in most studies it is unclear whether FDI in the non-financial sector is the causal influence on the FDI of banks. Causation may run the other way, or some omitted factor may explain both. Although most studies attempt to control for omitted factors such as market size (proxied for by GDP or population) or foreign trade, these controls may not be sufficient. Even if a convincing link is found between non-financial FDI and FDI by banks, this positive association does not necessarily mean that foreign banks are providing services exclusively or even primarily to the affiliates of clients from their home countries.
Research into the expansion of Japanese banks, which may have the strongest presence in Asia, indicates that although they often may enter foreign markets on the heels of foreign direct investment by clients in the manufacturing sector, they eventually begin to serve local clients as well—issuing trade credits for related suppliers for example. Pomerleau and Vojta (2001) find that in the Philippines, Japanese banks tend to focus on servicing large Japanese corporations seeking to finance their foreign direct investment rather than multinational corporations or local customers. Thus they have little effect on the domestic banks in the Philippines. Other studies (Seth and Quijano (1991), Nolle and Seth (1996)) have found that Japanese banks initially enter in pursuit of their customers abroad, but there is evidence that they then expand their customer base to include domestic companies. For example, Yamori (1998) investigates the locational choice of Japanese banks and finds that FDI, particularly from the manufacturing industry, is an important determinant of the location choice of Japanese financial institutions, suggesting that Japanese banks follow their customers-the Japanese manufacturing industry. However, unlike U.S. banks expansion patterns abroad, the expansion patterns of Japanese banks seem to also be affected by the size of local banking opportunities in the host countries as measured by the log of per capita GNP in the host country. Looking at the expansion of Japanese banks into the United States, Peek and Rosengren (1998) find that their customer base in the 1980s included “numerous domestic U.S. companies.”

Of course, foreign bank activity is determined not just by nationality, but also by the particular strategy of the bank in question. Deutsche Bank and other money center banks such as Chase-JP Morgan, have withdrawn somewhat from emerging markets, limiting their credit exposure in order to focus on investment banking and private banking activities. These banks may offer some trade finance, but mostly provide advanced treasury and capital market products, cross-border underwriting and M&A services-niche markets that offer little direct competition for domestic markets. Following a completely different strategy, at least three foreign banks operating in emerging economies-local subsidiaries of Citibank, HSBC and Standard Chartered-have done well in the retail banking market by targeting high-end consumer and commercial business and offering innovative and high-quality retail services, credit cards, and mortgage and personal lending. There is also some evidence that in the mid-1990s, Japanese banks shifted their emphasis in Asia away from wholesale toward retail banking (McCauley and Yeaple (1994)).

Overall, research to date suggests that greater openness to foreign financial institutions will benefit emerging markets in Asia. Although the activities of some foreign entrants may provide competition for domestic banks, this will spur efficiency in the banking sector for both foreign and domestic players. Moreover, the role of domestic financial institutions will not be eliminated by the entry of foreign banks. By capitalizing on their local knowledge and relationships in the retail and small and medium enterprise loan markets, domestic banks will continue to play a crucial role in the financial system. Very few foreign banks are likely to penetrate these markets to a meaningful degree. Rather, foreign banks are likely to focus on areas where they have demonstrated a comparative advantage: foreign exchange and derivatives trading, global underwriting of bonds and equities, cross-border M&As, trade finance and investment

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10 As noted above, it is difficult to categorize banks as solely “wholesale” or solely “retail” banks.
management services. Thus, rather than substituting for domestic bank services, they will complement the range of wholesale and retail products offered by domestic banks.

5.2. Stability

Because of the enormous economic damage caused by the Asian crisis of 1997, the main concern of policymakers in Asia is often not the efficiency of or even competition from foreign banks, but stability. Foreign banks tend to be more specialized in foreign currency lending (Pigott (1986)), and as shown in Table 4 below, hold a higher percentage of both assets and liabilities in foreign currency. Note that the spread between the percentage of foreign liabilities and foreign assets is much higher for foreign banks than for domestic ones, indicating that foreign banks have higher net external positions.

| Table 4. Foreign Assets and Liabilities of Foreign and Domestic Banks in Asia |
|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                            | Domestic Banks              | Foreign Banks               |                            |
|                            | Foreign Assets | Foreign Liabilities*     | Foreign Assets | Foreign Liabilities*     |
| Indonesia                  | 5.42%          | 5.11% (18.10%)            | 8.26%          | 43.01% (69.05%)            |
| Korea                      | 7.76%          | 7.17% (13.17%)            | 9.33%          | 65.1% (65.29%)            |
| Malaysia                   | 2.91%          | 4.09%                     | 1.43%          | 11.63%                     |

* Foreign liabilities including foreign currency deposits are in parentheses.

These issues have brought concerns that foreign banks may withdraw more rapidly than domestic banks in the event of crisis (Park (2002)), or even that the very presence of foreign banks may increase the likelihood of a crisis. However, because foreign banks can rely upon an internationally-diversified funding base-in particular advances from the parent (Terrell (1979), (1986))-proponents of foreign bank access point out that they are likely to be less vulnerable to business cycles in the host country, and thus may provide a more stable source of credit than domestic banks. By diversifying the host country’s overall banking system, international banks may actually stabilize it (Meltzer (1998)), making it less vulnerable to crisis.

Empirical evidence suggests that foreign banks remain sensitive to economic conditions in their home countries. Lending by Japanese banks operating branches in the United States has been shown to be sensitive to the financial condition of the parent bank (Peek and Rosengren (1997), (2000a)), and U.S. bank claims on Latin American and Asian emerging markets and industrialized countries have been shown to be sensitive to U.S. macroeconomic conditions (Goldberg and Kinney (2001)). However, the operations of foreign banks appear to be insensitive to macroeconomic conditions in the host country, at least for emerging markets (Goldberg and Kinney (2001)). This suggests that foreign banks can play an important role in providing credit during economic downturns. As long as the business cycle of the host country and the home country are not perfectly synchronized, this situation can actually be a stabilizing force. Indeed, it has been shown empirically that foreign bank penetration rose in the wake of crisis in Latin America (Peek and Rosengren (2002b)), and we are currently seeing the same trend in post-crisis Asia. Thus, foreign banks seem to play an important role in
supplying credit when domestic institutions are unable to do so and in recapitalizing the banking sector in crisis-hit economies.

There is also the question of whether the lending of existing foreign banks is more volatile than that of domestic banks, and whether existing foreign banks are more likely than domestic banks to withdraw in the face of crisis.

Overall, there seems to be little evidence to support this. On the contrary, studies on the behavior of foreign banks in Latin America during the Tequila crisis of 1994-1995 provide evidence that foreign banks may actually increase stability in crisis hit countries (Goldberg and Kinney (2000), Crystal and Goldberg (2001), Peek and Rosengren (2000b)). Goldberg and Kinney (2000) investigate the behavior of foreign and domestic banks in Argentina and Mexico for the period 1994-1999 and fail to find any support for the argument that foreign banks contribute to instability or are excessively volatile in their responses to market signals. In fact, the authors find that foreign banks exhibited stronger loan growth and lower volatility of lending in the period surrounding the 1994-1995 Tequila crisis. Crystal, Dages and Goldberg (2001) report similar results in their study of foreign bank activity in Chile, Columbia and Argentina: foreign banks showed higher and more stable average loan growth, higher average provisioning expense, comparable or weaker profitability, and higher risk-based capital ratios than domestic banks. These data echo the findings of Peek and Rosengren (2000b) for Argentina, Brazil and Mexico. They found that despite economic problems in the host countries, foreign bank subsidiaries there have continued to grow. Contrary to the concerns of policymakers in developing countries, “foreign bank subsidiaries did not pull back in response to economic problems in the host country; rather, they viewed the economic problems as providing opportunities to expand, either by acquisition or by internal growth of existing subsidiaries.” These findings suggest that foreign ownership may provide an important stabilizing influence in emerging market financial systems.

Table 5 presents average loan growth rates for domestic banks and foreign bank branches and subsidiaries operating in Indonesia, Korea and Malaysia both before and after the crisis of 1997. As in Latin America, there appears to be no statistically significant difference between loan growth rates for domestic and foreign financial institutions. Although there has been little rigorous research into the influence of foreign banks on Asian emerging markets, there is some evidence that those that were already operating in Asia prior to the 1997 crisis contributed to stability in the region. In Indonesia, foreign banks were spared the bank runs that forced domestic banks to rebuild liquidity and curtail lending. In addition, exchange rate and interest rate shocks to the Indonesian economy had a much more adverse effect on domestic bank capital than on foreign bank capital, meaning that the supply of bank loans from foreign banks was less affected (Aziz et. al. (2002)). Although foreign banks could not supply enough credit to completely offset the decrease in supply by domestic banks, they clearly played a stabilizing influence during the crisis.

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11 Due to data limitations, Table 5 does not include cross-border lending by off-shore financial centers, which may be more volatile.
### Table 5. Loan Growth of Domestic and Foreign Banks in Pre- and Post-Crisis Asia

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic</td>
<td>28.26 (1.00)</td>
<td>18.56 (4.04)</td>
</tr>
<tr>
<td>Foreign</td>
<td>22.19 (2.03)</td>
<td>11.50 (5.34)</td>
</tr>
<tr>
<td>Korea</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic</td>
<td>17.16 (6.52)</td>
<td>19.40 (1.78)</td>
</tr>
<tr>
<td>Foreign</td>
<td>6.52 (1.64)</td>
<td>13.79 (4.97)</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic</td>
<td>n.a.</td>
<td>5.23 (0.73)</td>
</tr>
<tr>
<td>Foreign</td>
<td>n.a.</td>
<td>8.30 (1.39)</td>
</tr>
</tbody>
</table>

* Standard deviations are in parentheses.

However, the stability of foreign bank lending during banking crises may depend upon the mode of entry of the institutions. Recent studies indicate that subsidiaries allow foreign banks to provide a wider range of activities and bring greater stability in lending to host countries than do branches, although empirical research in this area is limited (Clarke and Sanches (2001)). Table 6 shows the average loan growth rates for foreign-owned branches and foreign-owned subsidiaries operating in Indonesia and Thailand. In both countries, foreign bank branches have statistically significantly higher loan growth rates than do foreign bank subsidiaries, but this higher growth is accompanied by higher volatility in lending as well.

### Table 6. Average Loan Growth Rates of Foreign Banks in Indonesia and Thailand

<table>
<thead>
<tr>
<th>Country</th>
<th>Branches</th>
<th>Subsidiaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>17.75 (6.45)</td>
<td>3.04 (4.19)</td>
</tr>
<tr>
<td>Thailand</td>
<td>40.06 (17.80)</td>
<td>5.37 (2.64)</td>
</tr>
</tbody>
</table>

* Standard deviations are in parentheses.
Even more volatile than the lending of foreign bank branches is that of off-shore foreign banks. Although “off-shore financial activities are not inimical to global financial stability provided they are well supervised and supervisory authorities co-operate”\textsuperscript{12} (BIS (2000)), there is substantial evidence that off-shore lenders actually retreat in times of crisis. During the Tequila crisis in Latin America, off-shore lenders pulled back in response to the economic problems in the host country, unlike foreign bank subsidiaries, who took the opportunity to expand their operations (Peek and Rosengren (2000b)). During the Asian crisis, while U.S. money center banks generally maintained the operations of their offshore branches and subsidiaries, cross border lending into Asia plummeted\textsuperscript{13} (Palmer (2000)).

It is difficult to empirically document the role of offshore financial centers in capital flight, since many of their activities are not included on the balance sheet. However, even aggregate data confirms that cross-border lending is more volatile than domestic lending or lending by foreign institutions that entered via branching or subsidiaries. Table 7 shows outstanding loans and credit before and after the Asian crisis of 1997 for Indonesia, Korea, Malaysia and Thailand. Cross-border claims in all these crisis hit economies fell substantially between 1996 and 1998. In most, outstanding loans by domestic banks fell or grew only slightly over the same period. Outstanding loans by foreign banks, however, grew significantly. This suggests that as in the case of Latin America during the Tequila crisis of 1994-1995, foreign bank subsidiaries and branches stepped in to provide loan demand that could not be met by domestic banks during the Asian crisis. However, cross-border lending was actually more volatile than any other types of lending, and exacerbated, if not to some extent caused, the credit crunch that accompanied the crisis. These large disparities in the lending behavior of foreign banks that are present via subsidiaries or branches, versus those that are engaged primarily in cross border lending, has led to recommendations that policymakers concerned about the stability of foreign bank lending should encourage cross-border lending through brick and mortar subsidiary operations rather than through offshore lending (Peek and Rosengren (2000b)).

\textsuperscript{12} BIS (2000) provides a grouping of offshore financial centers into categories reflecting their perceived quality of supervision and degree of co-operation.

\textsuperscript{13} For example, cross-border lending to Asia fell 36% between June 1997 and June 1999, but local claims of foreign banks declined just 6%.

NB: Cross-border claims are those booked outside the foreign counterparty’s home country, usually at the U.S. bank’s head office in the United States. This type of claim is usually denominated in U.S. dollars. Local claims on foreign counterparties are those booked in the local offices of the reporting bank-offices located in the country of the counterparty.
Table 7. Outstanding Loans in Pre- and Post-Crisis Asia

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td></td>
<td></td>
<td>58.7</td>
<td>45.0</td>
<td>−23.3%</td>
</tr>
<tr>
<td>Local Lending (units: Rp bil)</td>
<td>Foreign</td>
<td>12,412</td>
<td>32,225</td>
<td>159.6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Domestic</td>
<td>71,153.4</td>
<td>125,110</td>
<td>75.8%</td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>Cross-Border Claims of BIS Banks (units: $ bil)</td>
<td>Total Claims</td>
<td>104.2</td>
<td>67.3</td>
<td>−35.4%</td>
</tr>
<tr>
<td>Local Lending (units: Won bil)</td>
<td>Foreign</td>
<td>7,361.9</td>
<td>8,364.4</td>
<td>13.6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Domestic</td>
<td>148,726.7</td>
<td>152,958.9</td>
<td>2.9%</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>Cross-Border Claims of BIS Banks (units: $ bil)</td>
<td>Total Claims</td>
<td>28.8</td>
<td>18.9</td>
<td>−34.4%</td>
</tr>
<tr>
<td>Local Lending (units: RM bil)</td>
<td>Foreign</td>
<td>47.9</td>
<td>66.1</td>
<td>38.0%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Domestic</td>
<td>178.5</td>
<td>246.6</td>
<td>38.2%</td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>Cross-Border Claims of BIS Banks (units: $ bil)</td>
<td>Total Claims</td>
<td>69.4</td>
<td>39.4</td>
<td>−43.2%</td>
</tr>
<tr>
<td>Local Lending (units: Baht bil)</td>
<td>Foreign</td>
<td>143.8</td>
<td>173.4</td>
<td>20.6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Domestic</td>
<td>4,111.2</td>
<td>3,762.9</td>
<td>−8.5%</td>
<td></td>
</tr>
</tbody>
</table>

* Cross-Border claims of BIS banks includes non-local currency claims by BIS reporting banks’ affiliates in vis-à-vis countries. Local foreign banks lending includes lending in non-local currency as well as lending in local currency. The rate of change in foreign banks’ local lending as measured in billions of USD was −22.90 % for Indonesia, −20.59 % for Korea, −8.12 % for Malaysia, and for −14.95 % for Thailand.

It is important to keep in mind, however, that overall, cross-country studies on the relationship between foreign bank entry and the incidence of banking crisis suggest that the presence of foreign banks, or even just opening to foreign bank entry, reduces the likelihood of crises. Investigating the period 1988-1995, Demirguc-Kunt and Min (1998) show that foreign bank entry is associated with a decreased incidence of local banking crises. A study by Levine (1999), building upon the work of Demirguc-Kunt and Min (1998), uses the same multivariate logit model to relate the probability of a banking crisis to a series of macroeconomic and banking system health indicators, including the number of foreign banks relative to total banks. Levine’s study reports that the foreign bank share variable has a statistically significant negative coefficient, leading to the conclusion that greater foreign bank participation was a stabilizing influence after controlling for other factors. Barth and Levine (2001) find that it is not foreign bank ownership per se that is linked to the likelihood of a banking crisis, but rather limitations on foreign-bank entry and ownership. Independent of actual foreign
bank entry, they find that the likelihood of a major banking crisis is positively associated with greater limitations on foreign-bank participation.

6. Conclusions

The following conclusions emerge from this overview of the role of foreign banks in Asia.

In post-crisis Asia, foreign banks operate on a much more even playing field with domestic banks compared to the past. Branching restrictions, as well as special treatment for the branches of foreign banks, were largely phased out with the financial sector liberalization that was implemented in most countries in the 1980s. More recently, ceilings on the shares of foreign partners in joint ventures have been raised substantially and in most cases eliminated.

However, as a legacy of the previously heavily regulated environment, the penetration of foreign banks in Asia—whether measured in terms of loans, deposits or assets—is very low, lower than in Central Europe or Latin America even in the early 1990s. This fact is observed even when taking into account the activity of foreign banks via branches, the mode of entry most used by foreign banks in Asia.

Looking forward, the presence of foreign banks in Asia is expected to increase rapidly, due to both the deregulation already in place and the progress being made by the World Trade Organization on the Generalized Agreement on Trade in Services. Although many developing countries have already unilaterally liberalized trade in services and entry into the financial sector, the signing of the GATS will reinforce the trend toward financial service liberalization, and lock countries into a commitment to maintain the liberalization they have instituted thus far. Finally, foreign financial institutions are increasingly being welcomed in Asian countries as part of the recapitalization of the banking sector in the wake of the crisis. As academic research has shown, banking crises bring increased foreign participation in the banking sector.

This increase in foreign participation in the banking sector should be welcomed by policymakers. The presence of foreign banks will likely improve the financial infrastructure, including accounting and transparency, by stimulating the establishment and strengthening of rating agencies, auditors, credit bureaus. Foreign banks effectively “import” financial system supervision and supervisory skills from home country regulators, and these skills may spill over to the host country.

In addition, foreign banks can help improve financial services within a country both by offering services directly and through increased competition with domestic banks. Increased competition from foreign entrants stimulates the efficiency of both foreign and domestic players in the market. Fears that foreign entrants will take over and dominate the host country’s banking sector are unsubstantiated, as studies show that foreign banks tend to focus on niche markets that complement rather than substitute for services and products offered by domestic banks. Thus, domestic financial institutions will continue to play a crucial role in the financial system in Asia.

In addition to the benefits of an improved financial infrastructure and increased efficiency in the banking sector, foreign banks contribute to the stability of the financial sector. They tend to be more internationally diversified than their domestic counterparts, rendering them less sensitive to macroeconomic conditions in the host country. Thus, they are able to provide credit when domestic banks cannot, helping to
smooth out business cycle fluctuations. The experience of Latin America in 1994-1995 shows that foreign banks can play an important role in recapitalizing the banking sector following banking crises. This trend has also been seen more recently in post-crisis Asia. More importantly, research has shown that by diversifying the host country’s banking system overall, international banks actually reduce the likelihood of crisis in the first place.

One caveat, however, is that the mode of foreign entry matters. Until recently, almost all foreign entry into the banking sectors of Asian countries has been through offshore lending institutions or branching, rather than through fully-owned subsidiaries or majority-owned joint ventures. There is clear evidence that offshore lending is much more volatile than lending by “brick and mortar” foreign banks. Lending by branches, subsidiaries and joint venture banks may have supervisory advantages as well. As witnessed during the Asian crisis, offshore lending tends to be more difficult for the host country supervisor to monitor or influence (Peek and Rosengren (2000b)). Although empirical studies on the relative merits of foreign bank branches versus subsidiaries are limited, recent studies suggest that foreign bank subsidiaries are able to provide a wider range of financial services (Clarke and Sanches (2001), Miller and Parkhe (1998)), thereby contributing to stability. Indeed, the data presented in this study indicate that subsidiary lending is more stable than that of foreign bank branches.

In summary, Asian countries stand poised to gain much from the entry of foreign financial institutions in the coming years. However, to fully realize these gains, policymakers need to welcome the entry of foreign financial institutions and move away from offshore institutions and branch-based entry, allowing foreign players to enter via fully owned subsidiaries and joint ventures.
Appendix: List of Financial Institutions Used in the Analysis

Indonesia

1. Private National Domestic Banks

Bank Artah Graha
Bank Bali (IBRA)
Bank Buana Indonesia
Bank Bukopin (Recapitalized by State of Indonesia)
Bank Bumi Arta
Bank Central Asia (IBRA)
Bank Danamon Indonesia Tbk (IBRA)
Bank Ekonomi Rahardja
Bank Internasional Indonesia Tbk (IBRA)
Bank Keaswan
Bank Lippo Tbk (IBRA)
Bank Mayapada Internasional
Bank Metro Express
Bank Niaga
Bank Nusantara Parahyangan
Bank Prima Express (Recapitalized by State of Indonesia)
Bank Shinta Indonesia
Bank Universal (Recapitalized by State of Indonesia)

a. Joint (Minority Foreign Owned) Banks

Bank Ficonesia (25% DE, 0.49% US)
Bank Inter-Pacific (20% JP, 12% FR)
P.T. Bank CIC Internasional, Tbk (25% US)
Panin Bank - Pan Indonesia Bank (29% AU)

2. Majority Foreign-Owned Banks

ANZ Panin Bank
Bank BNP Paribas (99.98% FR)
Bank Credit Lyonnais Indonesia (97% FR)
Bank Daiwa Perdania (48% JP)
Bank Fuji International Indonesia (80% JP)
Bank Keppel Tat Lee Buana (85% SG)
Bank Multicor (90% GB)

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14 Data for Bank Antardaerah, Bank Arta Niaga Kencana, Bank Artamedia, Bank Bumiputera Indonesia, Bank Ganesha, Bank Indo Monex, Bank Internasional Indonesia, Bank Maspion Indonesia, Bank Mega TBK, Bank Mestika Dharma, Bank Nisp, Bank Nusa Internasional, Bank Nusantara Parahyangan, Bank Pikko, Bank Royal Indonesia, Bank UIB and Bank Unibank, were unavailable in Bankscope for either 1996 or 1998.

15 Data for Bank Mashill Utama (18% BE) were not available in Bankscope for 1998.

16 Data were not available in Bankscope for 1996 or 1998 for some banks: Bank Chinatrust Indonesia (99% TW), Bank Commonwealth (99% AU), Bank DBS Indonesia, Bank Hanvit Indonesia (82% KR), Bank Maybank Indocor (91% MY) and ING Indonesia Bank (85% NL).
Bank OCBC-NISP (85% SG)
Bank Paribas - BBD Indonesia (88% FR)
Bank Rabobank International Indonesia (96% NL)
Bank Sakura Swadharma
Bank Societe Generale Indonesia (100% FR)
Bank Sumitomo Mitsui Indonesia (98% JP)
Bank UOB Indonesia (80% SG)
IBJ Indonesia Bank (85% JP)
Indonesia Dai-Ichi Kangyo Bank (85% JP)
Indosuez Indonesia Bank
Korea Exchange Bank Danamon (85% KR)
Tokai Lippo Bank

3. Foreign Bank Branches
ABN Amro
American Express Bank
Bangkok Bank Ltd.
Bank Merincorp
Bank Multicor
Bank of America
Bank of Tokyo Mitsubishi
Chase Manhattan Bank
Citibank N.A.
Deutsche Bank AG
HSBC

Korea

1. Nationwide Domestic Banks\(^{17}\) (11)
Chohung Bank\(^{18}\)
H&CB
Hana Bank\(^{19}\)
Hanvit Bank\(^{20}\)
Seoul Bank\(^{21}\)
Shinhan Bank
Peace Bank of Korea

a. Joint (Minority Foreign Owned) Banks
Kookmin Bank (11% Goldman Sachs 5% Bank of New York, 2% Government of Singapore)

\(^{17}\) All nationwide domestic banks are privately owned unless temporarily nationalized due to low capital.
\(^{18}\) 80% owned by Korea Deposit Insurance Corporation as part of a recapitalization plan.
\(^{19}\) Absorbed Boram Bank.
\(^{20}\) Formed by the merger of 2 commercial banks and some local banks, then nationalized by the government for recapitalization. Currently 95% owned by State of Korea.
\(^{21}\) Nationalized. Currently 98% owned by Korea Deposit Insurance Corporation.
Korea Exchange Bank (32% German owned)
Koram Bank (40% JP Morgan, 10% Bank of America, 11% private foreign shareholders)

2. Local Domestic Banks (6)
Cheju Bank
Daegu Bank
Jeonbuk Bank
Kwangju Bank
Kyongnam Bank
Pusan Bank

3. Majority Foreign-Owned Banks
Korea First Bank (51% Newbridge Capital as of 1999)

4. Foreign Bank Branches
ABN Amro
Algemene Bank Netherland NV.
American Express Bank Ltd. (2)
Arab Bank Ltd.
Asahi Bank
Australia and New Zealand Bank
Bank Mellate
Bank of America
Bank of California, Bank
Bank of China
Bank of Hawaii
Bank of Montreal
Bank of New York (2)
Bank of Nova Scotia
Bank of Tokyo Mitsubishi
Bank One
Bankers Trust Company
Banque Indosuez
Banque National De Paris
Banque Paribas
Barclays Bank Ltd. (2)
Chase Manhattan Bank
Citibank (16)
Credit Agricole Indosuez
Credit Lyonnais
Credit Lyonnais (2)
Credit Suisse First Boston Bank
Dai-Ichi Kangyo Bank
Daiwa Bank
Deutche Bank
Development Bank of Singapore
First Interstate Bank of California
First National Bank of Boston
First National Bank of Boston
First Union National Bank
Fleet National Bank
Fuji Bank
HSBC (6)
Indian Overseas Bank
Industrial and Commercial Bank
ING Barings
International Bank of Singapore
Long Term Credit Bank of Japan
Metrobank
Mitsubishi Trust Banking
Mitsui Bank Ltd.
Morgan Bank
National Australia Bank Ltd.
National Bank of Canada
National Bank of Pakistan
National Westminster Bank PLC
Overseas Chinese Banking Corporation
Royal Bank of Canada
Sanwa Bank
Security Pacific National Bank
Security Pacific National Bank
Societe Generale
Standard Chartered Bank
State Street Bank
Sumitomo Bank Ltd.
Tokai Bank
UBS Warburg
Union Bank of California
Union De Banques Arabes Et Francais
United Overseas Bank Ltd.
Westpac Banking Corp.
Yamaguchi Bank

**Malaysia**

**1. Domestic Commercial Banks**

Affin Bank Berhad
Alliance Bank Malaysia Berhad
Arab Malaysian Bank Berhad
Bank Utama (Malaysia) Berhad
Bumiputra Commerce Bank Berhad
EON Bank Berhad
Hong Leong Bank Berhad
International Bank Malaysia Bhd
Malayan Banking Berhad - Maybank
Public Bank Berhad
Southern Bank Berhad
Wah Tat Bank Berhad

a. Joint (Minority Foreign Owned) Banks
   United Overseas Bank (Malaysia) Berhad (45% SG)

2. Majority Foreign-Owned Commercial Banks
ABN Amro Bank Behad (100% NL)
Bangkok Bank Behad (100% TH)
Bank of America (Malaysia) Berhad
Bank of Nova Scotia Berhad (100% CA)
Bank of Tokyo-Mitsubishi (Malaysia) Berhad
Chase Manhattan Bank (M) Berhad (100% US)
Citibank Berhad (100% US)
Deutsche Bank (Malaysia) Berhad (100% US)
HSBC Bank Malaysia Berhad
OCBC Bank (Malaysia) Berhad (87% SG)
Overseas Union Bank (Malaysia) Berhad (100% SG)
Standard Chartered Bank Malaysia Berhad (100% NL)

Thailand

1. Domestic Commercial Banks
   Bangkok Bank PCL
   Bangkok Metropolitan Bank
   BankThai
   Siam City Bank

2. Majority Foreign-Owned Commercial Banks
   Bank of Asia PCL (79% ABN Amro)
   DBS Thai Danu Bank PCL (50.3% Development Bank of Singapore as of 1999)
   Standard Chartered Nakornthon Bank PCL (75% Standard Chartered as of 1999)
   UOB Radanasin Bank PCL (75% UOB of Singapore as of 1999)

3. Branches Foreign Bank
   Chase Manhattan Bank
   Citibank, N.A.
   The Hongkong Shangai Banking Corp. (HSBC)
   Standard Chartered Bank

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22 8% Keppel Capital Holdings of Singapore.
23 Bangkok Bank of Commerce, Bank of Ayudhya, Krung Thai Bank, Siam Commercial Bank, Thai Farmers Bank and Thai Military Bank loan data were not available for 1996 and/or 1998.
References


