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Future Role of Foreign Banks in Asia

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Good Bank—Bad Bank?

Although the Asian Crisis has brought consensus on the necessity of strong domestic financial systems, there is less agreement as to the role of foreign banks in achieving the goals of economic growth and stabilization. Foreign banks are one obvious source to turn to for the capital so badly needed in the region. Proponents of foreign bank entry argue that foreign participation is a vital part of creating a vibrant financial system including a wide range of financial services and industries.

But policymakers in the region worry about the potential bad 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 to foreign participation. In particular, there are concerns that foreign bank entry will expedite de facto capital account opening, perhaps contributing to instability of financial markets and the banking sector.

A recent ADB Institute study on the role of foreign banks in post-crisis Asia comprehensively reviews the arguments for and against foreign bank participation in emerging markets and surveys the empirical evidence available on the issues of efficiency, competition and stability.

Foreign Bank Penetration of Asia is Still Low

The study provides 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 because they have failed to account for entry via branching, the mode of entry most common in Asian countries. There are advantages and disadvantages of entry via branching versus the alternative of merger and acquisition.

However, even after accounting for the presence of foreign banks via branching, the participation of foreign institutions in Asia is still much lower than that seen in other emerging market economies in Latin America and Central and Eastern Europe.

Regulatory Improvements Encourage Foreign Entry

The low penetration of foreign banks in Asia is largely due to regulatory restrictions. However, due to regulatory changes enacted in the wake of the 1997 Asian Crisis, the participation of foreign banks in Asia is expected to increase in coming years. This will have significant effects on domestic institutions already operating in Asia and on the banking sector as a whole.

Level Playing Field is in Sight

From our overview of the role of foreign banks in Asia, the following facts have emerged.

In post-crisis Asia, foreign banks now operate on a much more even playing field with domestic banks than ever before. Branching restrictions, as well as special treatment geared toward branches of foreign banks, have largely been phased out with the financial sector liberalization occurring in most countries in the 1980s. More recently, ceilings on the shares foreign partners may hold in joint ventures have been raised substantially and in most cases eliminated.

Nevertheless, due to 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 the penetration of foreign banks into 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 operating in Asia.

Effect of Generalized Agreement on Trade in Services

Looking forward, the presence of foreign banks in Asia is expected to increase rapidly due to the deregulation already in place and the progress being made by the World Trade Organization on the Generalized Agreement on Trade in Services (GATS).

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 services liberalization already observed in many emerging market economies and lock countries in to a commitment to maintain the liberalization in financial services which they have instituted thus far.

Recapitalization after the Crisis

Foreign financial institutions are increasingly being welcomed in Asian countries as part of the recapitalization of the banking sector in the wake of the Asian crisis. As academic research has shown, banking crises invariably bring increased foreign participation in the banking sector.

Upside from Foreign Participation

The increase in foreign participation in the banking sector should be welcomed by policymakers in those countries. The presence of foreign banks will likely improve the financial infrastructure, including accounting and transparency, by stimulating the presence of rating agencies, auditors, and 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.

Increased Competition is Not all Bad

In addition to the financial infrastructure, foreign banks can help improve financial services within a country both by offering those services directly and through increased competition for the domestic banks.

Increased competition from foreign entrants stimulates the efficiency of both foreign and domestic players in the market. But fears that foreign entrants will take over and dominate the host country's banking sector are unsubstantiated since 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.

Stabilizing Influence on Bank Sector

In addition to the benefits of an improved financial infrastructure and increased efficiency in the banking sector, foreign banks will contribute to the stability of the financial sector.

Foreign banks tend to be more internationally diversified than domestic banks, rendering them less sensitive to macroeconomic conditions in the host country. Thus, foreign banks 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 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.

Be Wary of Volatility with Offshore Lending

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 fully-owned subsidiaries or majority-owned joint ventures.

There is clear evidence, however, 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 to influence. 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, thereby contributing to stability.

Indeed, the data presented in this ADB Institute study confirms that subsidiary lending is more stable than that of foreign bank branches.

Opportunities for Policymakers

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 into allowing foreign players to enter via fully-owned subsidiaries and joint ventures.