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**Do foreign banks improve
financial performance?**

Evidence from EU accession countries

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Abstract:

In the EU accession countries on their way toward joining the European Monetary Union (EMU), the share of foreign banks is extremely high. Usually, the presence of foreign banks is considered to have a positive effect on financial sector development, financial discipline, and institution building in emerging economies. In this paper, we question these findings. We show that financial development measured by traditional indicators does not depend on the presence of foreign banks. Rather, we show that the presence of foreign banks in Eastern European countries was accompanied by a reduction of non-performing loans and an improvement of legal institutions. (100 words)

Keywords: financial systems, foreign banks, EU accession

JEL classification: **G21, P34**

Do foreign banks improve financial performance?

Evidence from EU accession countries

1 Motivation

“The entry of foreign banks has generally been associated with improvements in the quality of both regulation and transparency, particularly if the entry of foreign banks is accompanied by the introduction of international standards of accounting and auditing.”

(World Bank 2001)

Central and Eastern Europe (CEE) is on its way toward joining the European Monetary Union (EMU). During the last ten years, most of the EU accession countries have made impressive progress in economic transition. In the financial sector, banking reforms have been undertaken and the legal foundations for financial institutions have been laid. Thus, important preconditions for EU accession have been formally met, diminishing the gap between the “old” and the “new” Europe. EU accession countries are still characterized, however, by an extremely high share of foreign banks.

The existing literature on financial development shows that the presence of foreign banks is usually closely linked to higher performance of the banking sector, increasing financial discipline, and improvement of the institutional framework (World Bank 2002; World Bank 2001). Many studies on the impact of foreign banks on financial development find the presence of foreign banks in emerging economies to offer overwhelming advantages. Despite the fact that a huge body of literature exists on the role of foreign banks in economic development, very few studies deal with the impact of foreign banks in EMU accession countries. Some of these papers find that foreign banks play the central role in increasing

banking sector performance (Derviz 1997; Pointbriand 2001; Bonin/Wachtel 2001). These findings are fully in line with the arguments concerning the presence of foreign banks in other emerging economies. In other words: for banking sector reform in the transition countries, the particularities of the overall institutional reconstruction process seem to be largely irrelevant.

In this paper, we question these findings. We show that financial development measured by indicators such as financial depth and the ratio of domestic credit to the private sector does not depend on the presence of foreign banks. Rather, we show that the presence of foreign banks in Eastern European countries was accompanied by a reduction of non-performing loans and an improvement of legal institutions.

The paper is organized as follows: we start with a short overview of the recent literature on foreign banks and financial development. In Section 3, we present anecdotal evidence on the presence of foreign banks in EMU accession countries. In Section 4, we offer an analysis of how foreign banks influence financial development, fiscal discipline, and institutional development in Eastern European countries. We close with some policy recommendations and ideas for future research.

Before starting, however, we would like to call attention to a few crucial points. First, in this paper we concentrate on banking sector development. We do so because in EU accession countries, financial markets are still dominated by banks, and the state's ambiguous roles are more likely to become obvious in banking than in other financial sectors. Second, there are still tremendous problems that complicate the measurement and evaluation of Eastern European financial sector development: data on the banking sector is not always available or consistent, and comparable time series are thus difficult to create. Third, an "optimal" financial system does not exist as a point of reference. When comparing the financial systems of accession countries with those of the European Union, as we undertake here, one has to keep in mind that even within the European Union, financial system integration is still underway.

2 What can be learned from the literature?

Financial theories generally emphasise the uniqueness of the financial market. Like no other market, it is confronted with the phenomenon of market failure. On the one hand, market failure justifies regulation (Stiglitz 1994)¹, and this leads to the state functioning as a neutral agent, creating and enforcing the rules of the game for the financial market. On the other, asymmetric information, transaction costs, and inter-temporality are deemed responsible for the existence of financial intermediaries, who according to Schumpeter collect and lend money but also select potentially successful entrepreneurs. On the micro level, empirical studies focus on questions of risk, for example, on optimal credit and portfolio allocation (Campbell et al. 2001). Nevertheless, an important precondition for portfolio diversification is that both a sufficient set of financial products and market-styled institutions already exist, or that they can easily be created.

Theoretically, when the institutional framework is weak, it might be possible to escape the dilemma by importing institutions from efficient market economies. Here, the openness of the domestic banking sector to foreign investors might be cause for concern. The presence of foreign banks has been found to offer at least three major advantages:

- Improvement of financial intermediation in the domestic market by importing financial institutions with a strong reputation from abroad and increasing trust in the banking sector
- Importing proper risk management and therefore reducing the transaction costs within the financial sector
- Helping to introduce a proper regulatory regime for the entire banking sector

Theoretical arguments for the presence of foreign banks are usually borrowed from the standard literature on financial intermediation (Diamond 1994). The existing models produce ambiguous results concerning the influence of foreign banks on the stability of the banking sector in the host country. Most of the models that find a strong positive effect of foreign banks are based on the idea that foreign banks do not operate autonomously and are influenced by the holding company. This holding company might operate as a lender of last resort and therefore stabilize the whole banking system in the host country in the case of a

¹ In financial theory three reasons for state regulation are discussed (Herring/Litan 1995, 49ff): preventing disruptions in financial markets, protecting consumers and achieving various social objectives.

financial crisis (Stein 1997). In general, these models argue that the presence of foreign banks leads to a stable credit supply.

Another strand of the theoretical literature argues that the contrary is the case; the credit supply of foreign banks may actually be less stable than that of domestic banks, possibly because the foreign banks react more pro-cyclically, or because their decision on business activities are influenced by economic changes not only in the host country but also in the home country (Molyneux/Seth 1998; Moshirian 2001). Additionally it is argued that opening up the domestic banking sector is a way of fostering bank competition. It can be argued that the increase in competition results in a decrease in entry costs (Cordella et al. 2002; Besanko/Thakor 1992; Chiappori et al. 1985).

While the theoretical work on foreign banks has produced ambiguous results, the empirical literature on the impact of foreign-owned banks mainly emphasises the positive impacts of their presence on host country financial development. These studies focus on three major questions:

- First the linkages between the presence of foreign banks and financial sector stability (World Bank 2002).
- Second, the relative performance of foreign and domestic banks (DeYoung/Nolle 1996; Claessens, Demirgüç-Kunt; Huizinga 2001). One result reported is that the entry of foreign banks led to both a reduction in overhead costs and an increase in the profitability of domestic banks.
- Third, the impact of foreign banks on financial development in emerging economies. Claessen/Jansen (2000) and Kono/Schuknecht (2000) find that the presence of foreign banks improves the efficiency of the domestic banking sector.²

The empirical literature tends to conclude that the presence of foreign banks has a positive effect on financial development in the host countries. Studies on the role of foreign banks in Latin America (Dages et al 2000; Crystal et al 2002) in particular show that the presence of foreign banks led to less volatile credit growth and therefore to a stabilization of the financial

² Additionally, some recent studies show that legal traditions are important for financial development (LaPorta et al. 1998; Beck/Demirgüç-Kunt 2001). Thus the presence of foreign banks is discussed in the context of an institutional analysis of financial systems, which is based on the distinction between common-law countries (USA, England) and civil-law countries (Germany, France, Scandinavia). In principle, investor protection is considered to foster growth better in common-law countries than in civil-law countries (irrespective of the specific Scandinavian, French or German traditions). Financial systems in civil-law countries, however, are more robust (Steinherr 2001).

sector in the host country. De Haas/Lelyveld (2002) arrive at similar conclusions concerning CEE countries. Nevertheless, a comprehensive study concerning the role of foreign banks in EMU accession countries is still pending. Furthermore, despite the fact that foreign banks account for more than 40 percent of total bank assets in most of the EMU accession countries, only a few studies exist on this country set (Bonin/Hasan/Wachtel 2004; Keren/Ofer 2001).

3 Letting foreign banks in: anecdotal evidence

Financial sector reform in EMU Accession countries is obviously a huge task. The kick-off to banking reform in Eastern Europe was the transformation to a two-tier banking system, the liberalisation of financial markets and the establishment of important legal banking regulations in the early 90s. During the nineties, banking reforms were carried out, and formerly non-existent security markets were established.³ Within this context, two major reform steps took place: the privatisation of state-owned banks and the opening-up of the domestic financial sector for foreign investors.

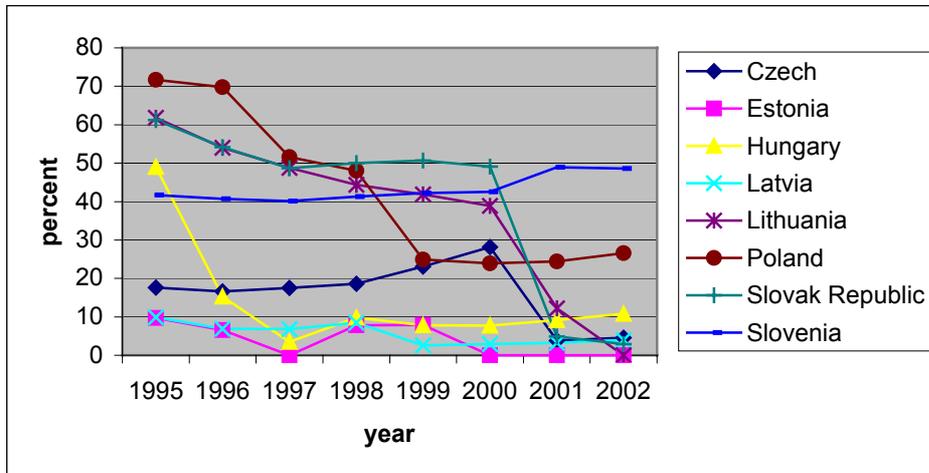
Until 1993/1994, state banks dominated the banking sector in the EMU accession countries. While in 1993/1994 state-owned banks controlled 70 percent or more of banking in Hungary, Poland and Slovakia, the share of those banks was around 50 percent in Lithuania and Slovenia. During this period, the share of state owned banks was significantly lower only in the Czech Republic and Estonia (Keren/Ofer 2001).

Privatisation of the banking sector in transition countries gained speed in 1995. Over a period of a few years starting in the mid-1990s, a drastic shift in the ownership structure took place. Now more than 50 percent of the banks belong to the private sector and the asset share of state-owned banks has dropped (Figure 1). Nevertheless, the speed of privatisation in the banking sector has varied widely among the EMU accession countries. In 2002, Estonia and the Czech Republic, as well as Lithuania, Latvia and the Slovak Republic had low shares of state-owned banks in total banking sector assets. A notable exception is Slovenia, where the state-owned banks still account for around 50 percent of total assets in the banking sector.⁴

³ We do not discuss financial systems under central planning. For an analysis, see Rodkey (1997, 145ff).

⁴ A share of 40 % state ownership is high compared to other EU accession countries and most of the "old" EU member countries. An exception is Germany, where private ownership is only about 60 percent of banking capital.

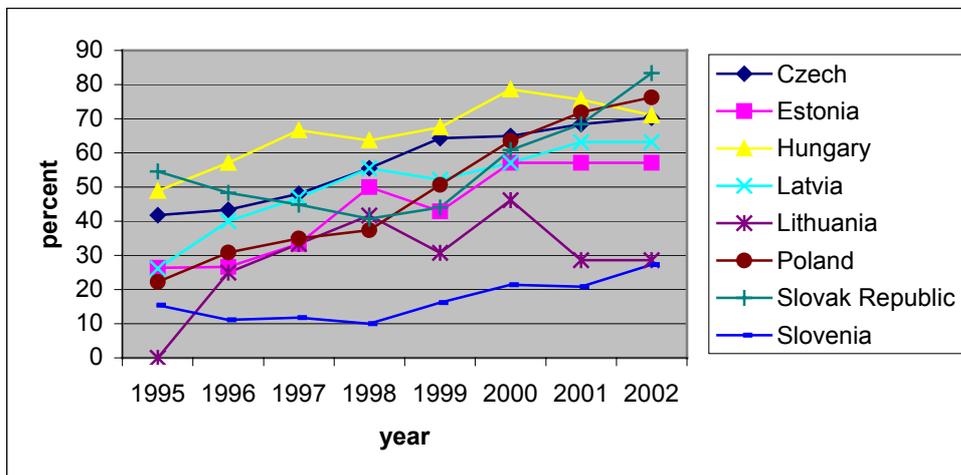
Figure 3-1
Asset share of state owned banks



Another indicator for the ongoing banking sector reform is the presence of foreign banks. The usual assumption is that foreigners bring capital, foster competition, and help develop western banking culture and governance practice. Thus the participation of foreigners is assumed to be advantageous to banking reform. Overall in Eastern Europe, participation of foreign-owned banks increased during the nineties. This does not only hold true for the number of banks, but also for the asset share of foreign-owned banks. An outstanding example is Estonia, with a share of major foreign ownership in total assets of 98 % in 2001 (European Central Bank 2002, 87). Nevertheless, the fact is that the remaining two percent of total assets are distributed among three domestic banks: these shares are too small to play any important role in the banking sector. But also in the other Baltic countries, as well as in Central European countries, foreigners play a dominant role in top banks. One exception is Slovenia, where barriers to market entry by foreigners still exist; here the importance of foreign banks compared to other EMU accession countries is relatively low, but increasing. There are noticeable differences in foreigners' countries of origin: the Baltic banking sector, for example, is dominated by Scandinavian Banks, while Poland shows no geographical concentration. As foreigners play an important role in bank development, they may in turn influence the characteristics of the national financial system. If this proves to be true, the Baltic countries can be expected to align their financial systems with the Scandinavian model, and countries like Poland will conform to Western European and even international financial systems.

It seems appropriate to analyse banking sector reform using an indicator that combines the aspects of privatisation and importance of foreign banks. In general, one observes a trend towards private banking and opening up of domestic financial markets. Nevertheless, EMU accession countries differ widely in how fast and how extensively these processes have taken effect. The leading country concerning the importance of non-state-owned banks and the presence of foreign banks is Estonia (Table 4-1); the most lagging country is Slovenia, where both indicators are very low. Poland is an example of a relatively slow privatisation of the banking sector connected with a relatively high importance of foreign banks.

Figure 3-2
Importance of Foreign Banks



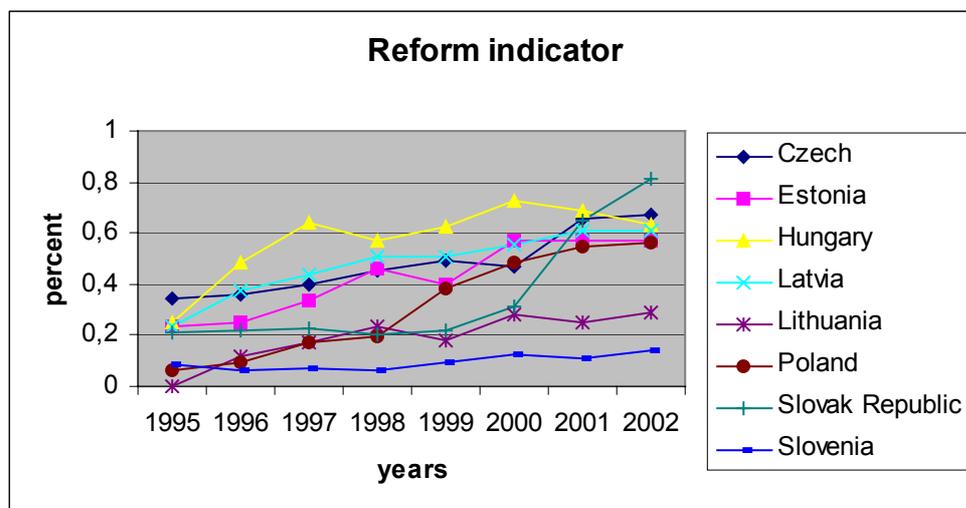
In the following, the indicator REFORM is compiled by multiplying "the asset share of non-state-owned banks" by the indicator "importance of foreign banks". The range of the indicator is between 1 and 0. A high presence of foreign banks in combination with high share of non-state-owned banks in total bank assets leads to a value around 1. Figure 3 clearly shows that using the combined indicator REFORM, Slovakia is the reform powerhouse of the region; here banking sector reform has gained momentum in recent years.

Table 3-1
Ranking in banking 2002

	Non-state-owned banks	Importance of foreign banks*	Asset share of foreign banks
Czech	5	5	5
Estonia	1	6	1
Hungary	6	4	4
Latvia	4	3	3
Lithuania	1	7	6
Poland	7	2	3
Slovak Republic	3	1	7
Slovenia	8	8	8

*ratio of foreign banks to total banks
Source: EBRD; authors' calculations

Figure 3-3
Reform indicator



4 Foreign banks – do they matter?

The crucial question is whether the presence of foreign banks has a positive impact on financial development in the EMU accession countries. Financial development itself is usually measured by the ratio of M2/GDP, which is assumed to reflect financial depth, or by the ratio of credit to the private sector to total domestic credit, which we call DOM. At a glance, it becomes clear that financial depth and DOM are highly and positively correlated (Table 4-1)

Table 4-1
Correlation Coefficients

	M2	DOM	EBRD_1	EBRD_2	FOREIGN	FOREIGN_2	NPL	STATE	MARKET	REFORM
M2	1,0000	0,7071	0,0886	0,1213	0,1246	-0,2131	0,1950	0,0325	0,3224	0,0697
DOM		1,0000	0,1241	0,1340	0,1327	-0,1319	0,1497	0,0570	0,2203	0,0705
EBRD_1			1,0000	0,6063	0,5252	0,5266	-0,5626	-0,5308	0,6278	0,6620
EBRD_2				1,0000	0,4829	0,3525	-0,2819	-0,1640	0,5242	0,4258
FOREIGN					1,0000	0,7041	-0,0506	-0,5233	-0,1763	0,9176
Foreign 2						1,0000	-0,3279	-0,6415	0,3243	0,7686
NPL							1,0000	0,5672	-0,3029	-0,3186
STATE								1,0000	-0,4224	-0,7866
MARKET									1,0000	0,4215
REFORM										1,0000

4.1 Institutional development

To reflect institutional development, we considered the EBRD transition indicator (EBRD 1) and the EBRD index of banking sector reform (EBRD 2). Both of the EBRD indices focus on reform progress and institutional development. EBRD 2 includes the enactment of banking laws and their enforcement as well as banking supervision and competition. While the two indicators are highly correlated, there is only a weak correlation between them and financial development – a very interesting finding since it leads to the conclusion that institutional and financial development are largely independent processes.

4.2 Foreign banks

The presence of foreign banks is reflected in the indicators FOREIGN I and II: the first shows the share of foreign banks in the banking sector, and the second shows the share of foreign banks in total assets of the banking sector. While there is a positive correlation between FOREIGN I and the financial and institutional development indicators, there is a slightly negative correlation between FOREIGN II and financial development. This finding is in

contrast to most of the recent studies on financial development in emerging economies. It might be due to the fact that the lending practices of foreign banks usually differ from those of domestic banks. Foreign banks might be more cautious and more risk-averse than domestic financial intermediaries, which in EMU accession countries are often closely connected to the state.

4.3 Non-performing loans

The presence of foreign banks is negatively correlated with the share of non-performing loans. At the same time state-owned banks' share of total banking assets is positively correlated with the share of non-performing loans. Therefore it can be assumed that privatisation and the presence of foreign banks have a positive effect on banking sector performance.

4.4 Market and Reform

Foreign I and Foreign II are positively correlated with the REFORM indicator. This result is expected because of the construction of the REFORM indicator. In contrast capital market development has only a slight correlation to the presence of foreign banks.

All in all, the presence of foreign banks is correlated to the institutional development and the existence of non-performing loans. There is no clear evidence that foreign banks contribute to financial development, measured in M2/GDP and the share of credit to the private sector to total credit. This might indicate that foreign banks play a major role in implementing "best practices" in the banking sector and improving the institutional framework. But these findings give only a first impression of the influence of foreign banks on financial sector development, and further investigation is necessary. However, at present the data is still relatively limited.

5 Conclusion

Financial sector reform is underway in all EMU accession countries, bringing with it privatisation and the entry of foreign banks. Nevertheless there are vast differences among these countries. Using a broader REFORM indicator that takes into account the two factors privatisation and the importance of foreign banks, we find that Slovakia has recently become the region's reform powerhouse. The asset share of non-state-owned banks and the asset share

of foreign banks has increased remarkably. In contrast, state-owned banks dominate the banking sector in Slovenia.

The high share of foreign banks is an outstanding feature in EMU accession countries. The theoretical literature deals with several effects of foreign banks on financial sector development: improvement of financial intermediation, import of proper risk management, and introduction of a proper regulatory regime. Using a simple correlation analysis, we find evidence that the presence of foreign banks has a positive impact on the financial sectors of EMU accession countries. First and foremost, foreign banks play a role in the context of institutional development and the reduction of non-performing loans. In contrast, their impact on traditional financial development indicators, as measured by financial depth and the importance of credit to the private sector, is ambiguous.

The spirit of opening up financial markets to foreigners in EMU accession countries might have positive effects on Western European countries. Here the banking sector is still dominated by domestic banks. In the end, both sides might get something out of institutional transfers. Thus old and new member states can learn from each other during the integration of the European financial markets. For the time being, increasing competition among financial systems within an enlarged Europe allowing for some heterogeneity seems to be the most promising development.

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