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# Explaining cross-border bank expansion in East Africa

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ABSTRACT

This paper investigates the drivers of bank foreign expansion in East Africa. Our results support the view that institutional quality is vital at the planning phase of banks' going-abroad decision but its importance is muted once the decision has been taken. Second, relatively competitive markets and weak market power at home seem to "push" banks abroad. Third, banks seek to exploit the benefits of their relative efficiency through regional expansion. Fourth, relatively higher foreign country inflation is a deterrent to banks expansion abroad. Finally, desire for greater earnings, economic integration, and follow-the-client hypothesis do not explain banks' foreign expansion decisions.

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## 1. Introduction

On the strength of recent empirical evidence that financial sector development leads economic development especially for economies at their take-off stage (e.g., Luintel and Khan, 1999; Beck and Demirguc-Kunt, 2006), development agencies, such as World Bank and IMF, have pushed for financial sector development and reforms among their member states, principally those in the emerging and developing world[3]. Reform measures have (unduly) targeted banking sector development (Senbet and Otchere, 2006), emphasizing divestment of government ownership of banks, opening of bank ownership to foreigners, and restructuring of regulations to encourage product innovation and credit provision to the private sector. Thus, while banks in Africa were, in the 1980s, predominantly government-owned and subject to restrictive regulations (Beck and Cull, 2013), many African countries have now relaxed ownership restrictions and enabled cross-border banking, resulting in increased foreign bank presence.

Foreign bank presence has generally been considered a positive development for financial markets of developing countries. Studies have found that the presence of foreign banks might help improve efficiency in the banking sector because

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[3] We highlight the key banking sector reform measures undertaken by East African countries in Appendix A.

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it intensifies competition and diminishes profitability of domestic banks which, in turn, respond by cutting down their overhead (Claessens et al., 2001; Koutsomanoli-Filippaki et al., 2009). Other studies, however, point out that foreign bank presence may cause declines in domestic lending (Giannetti and Ongena, 2009; Gormley, 2010), and deterioration in credit quality which may precipitate financial system instability especially during economic downturns (Schmidt, 2009). These arguments notwithstanding, cross-border banking has increased in recent times in the East African[4] region's financial markets. For instance, several commercial banks domiciled in Kenya, have recently extended their portfolios across Kenyan borders. Indeed, eleven banks had foreign operations by the end of 2012, all of which were within the East African region (Central Bank of Kenya, 2012b). The banks' foreign subsidiaries had a total of 282 branches as of December 2012, up from 223 in December 2011. Of the regional branches, 125 were in Uganda, 70 in Tanzania, 51 in Rwanda, 31 in South Sudan and 5 in Burundi. The foreign outlets had a total of 4780 employees; total assets valued at about KES 266.5 billion (USD 3.10 billion), of which KES 125.5 billion (USD 1.46 billion) were customers' loans; total deposits amounted to KES 202.6 billion (USD 2.36 billion). Foreign subsidiaries and branches contributed about 9.8% of Kenyan banks' total assets between 2007 and 2011.

While many Kenyan banks have been expanding into other East African countries, banks incorporated in other East African countries have not expanded, in corresponding numbers, into foreign markets, including Kenya[5]. For example, there is no Ugandan bank with foreign operations while Rwanda and Tanzania each have only one bank with foreign operations. Importantly, the share of total assets owned by foreign banks is very high for all the four countries, with Uganda leading the pack at 73.7%. Considering that Kenya's financial markets, institutional and legal systems are more advanced than others in the region (World Economic Forum, 2013), it is interesting to understand the factors that motivate the regionalization of banks in East Africa. This study is the first attempt to explore this issue.

Anecdotal evidence suggests some regionalization motives of Kenyan banks that form the basis for this inquiry (see Table A.1 in Appendix A for a summary). For instance, a comparison of cost-to-income ratios of banks in East Africa gives the impression that Kenyan banks are more efficient than Rwandan and Tanzanian banks but just as efficient as Ugandan banks. Similarly, the 5-bank concentration ratios, broadly speaking, indicate the possibility that banks operating in Kenya are faced with greater competition than their counterparts in East Africa. Further, bank penetration levels appear to suggest that target markets in Kenya are closer to saturation than markets in the rest of the region. Kenya also has the highest credit to domestic private sector as a proportion of GDP, implying that, as East African economies grow, other regional credit markets in the region would have more untapped business opportunities than Kenya's. Thus, one may conjecture that Kenyan banks, burdened by greater competition at home, seek to leverage their relatively better efficiency in an effort to profit from the relatively untapped, and potentially growing, regional markets. The return on equity data show that Kenyan banks are more profitable than their regional counterparts, suggesting that immediate profit-seeking may not be a strong motive for Kenyan banks' outward expansion. A detailed empirical investigation is necessary to test these conjectures and to improve our understanding of banks' regionalization phenomenon in East Africa.

Concurrent to the intra-regional banks expansion, banks that are foreign to East Africa have also increased their presence in the region, usually entering through the Kenyan market. World Bank's Global Financial Development data shows that the proportion of total banking assets owned by foreign banks in Kenya is over 30% indicating a high foreign bank presence. This raises a further question as to why Kenyan banks seek to grow into other countries when, apparently, there still remains untapped potential at home which foreign banks find appealing to exploit. Indeed, a majority of Kenya's adult population is still unreached by financial services (Beck et al., 2010; FSD, 2013): as of 2013, 25.4% of adult Kenyans were excluded from any form of financial services and only about 32.7% of adults had access to formal prudential financial services. Čihák and Podpiera (2005) have found that international banks are generally more efficient and more active in lending than domestic banks in East Africa: Are Kenyan banks being "pushed out" by competitive pressures exerted by more efficient foreign banks or being "pulled into" regional markets by the allure of better profit and growth prospects? Foreign expansion activities of banks in the East African region are a relatively recent phenomenon; it has attracted no empirical studies.

This paper contributes to the bank internationalization literature in several ways. First, our study is the first attempt to examine the motives for overseas expansion of banks in the developing (as opposed to emerging) world context. Given the relatively under-developed nature of economies in East Africa, the region provides an interesting test-bed for the study of bank behavior in an atypical setting. Second, drawing from the theoretical and empirical bank internationalization literature, and from our "anecdotal evidence" as outlined in the foregoing discussion, we hypothesize several factors that can explain regionalization motives of banks in East Africa and test our hypotheses through non-linear regression models, which are not extensively used in the extant empirical literature. Third, we have, for the first time in the bank internationalization literature, drawn parallels between the planning and the implementation phases of banks foreign expansion decisions. Our results suggests that institutional quality is important at the planning phase but its importance is muted at the implementation phase of banks' foreign expansion decisions and that banks *consider* going abroad due to competitive pressures currently exerted by their stronger, more efficient competitors as well as by their domestic competitors having expanded abroad.

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[4] East Africa is formally defined, for this study, to include six countries, namely Burundi, Kenya, Rwanda, Tanzania, South Sudan and Rwanda. See Appendix A for details.

[5] We cannot obtain adequate data for all variables of interest for Burundi and South Sudan, both of which are East African Community (EAC) member countries. For this reason, the two countries are left out of this study.

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