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Foreign bank presence and business regulations☆

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We examine the impact of foreign bank presence on a host countries' business regulatory environment. We employ a panel dataset of 87 developing economies for the 1995–2013 period and measure the efficiency of business regulations using the indices from the Heritage and the Fraser datasets. Our results show that foreign bank presence exerts a positive impact on the efficiency of business regulations; however, we find no evidence in favor of a more pronounced positive effect when foreign banks originate from countries that have a more efficient business regulatory environment. Moreover, host countries' administrative requirements and, particularly, bureaucracy costs benefit from a foreign bank presence; however, cost and time procedures to start a business do not.

1. Introduction

In a large number of countries, regulatory standards have been in the midst of a deregulatory dynamic in recent years (Drahos and Braithwaite, 2001). However, business regulations, a part of the wider regulatory spectrum, are of utmost importance for entrepreneurs, policy makers and academics. This importance is because the efficiency of the business regulatory environment translates into procedures and regulations that facilitate business entry, increase competition, ease market pricing and impede the creation of barriers to trade (Gwartney et al., 2015). This efficiency leads to an economic environment in which it is easier for entrepreneurship to flourish and firms to compete on an equal footing (World Bank, 2014), which results in enhanced economic growth prospects.

During the same period, the foreign bank presence soared in nearly all countries, following the financial liberalization wave which, however, exhibited different pace/speeds worldwide and, in certain cases, reversals, and which was bolstered by the increase in international trade. The geographic areas that exhibited a significant increase in foreign bank entry include Asia, Africa, Latin America, Middle East and Eastern Europe (Clarke et al., 2001; Lehner and Schnitzer, 2008; Claessens and Van Horen, 2014).

Most empirical research examines how business regulations and the institutional environment affect the establishment, behavior and operation of foreign banks and, more generally, of multinational companies (MNCs). In this paper, we focus on a different aspect: whether the foreign bank presence has a regulatory impact in host countries. Specifically, we explore the impact of the foreign bank presence on the efficiency of public business regulations in host developing countries, that is, regulations set and enforced by the sovereignty in which firms operate. Importantly, we address reverse causality and endogeneity concerns by using appropriate techniques and control regressions.

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The remainder of this paper is organized as follows. The second section reviews the literature on the foreign bank presence and business regulations, delineates the conceptual framework and formulates the research questions. The third section presents and discusses the data, and the fourth section presents the empirical methodology and analyzes the results. Finally, the fifth section concludes.

2. Literature review and conceptual framework

Financial sector FDI, i.e., foreign bank presence, along with real sector FDI, facilitates the integration of host economies into the international economy, the promotion of greater allocative efficiency and technology adoption, the moderation of the magnitude of business cycles, better wages and growth prospects (Goldberg, 2004). In addition to the effects on real economic activity, FDI exerts a positive influence on the institutional quality of the host countries in the long run, as Kwok and Tadesse (2006) illustrate for the case of corruption.

Focusing on the foreign bank presence, its beneficial impact on access to credit of the host countries' firms is documented in Giannetti and Ongena (2012) and Clarke et al. (2006). Consequently, foreign bank presence contributes to the host country's financial sector development through the increase in external financing and, hence, to the export share and trade balance improvement of manufactured goods (Beck, 2002).

However, these positive outcomes for the host economy are not limited to an increase in the amount of funds available to local firms. Recent empirical evidence documents another important aspect of the foreign bank presence related to the enlargement of the business opportunities for the domestic export-oriented sectors. Specifically, Paravasini et al. (2014) find that foreign banks are not substitutes to domestic banks in the provision of credit to local firms; the former have a comparative advantage over the latter in lending and specialization in the export market in which their headquarters are located. This finding is also verified by Williams (2002) within the context of the defensive expansion hypothesis.

Furthermore, because foreign banks tend to be more efficient than domestic banks in developing countries (Berger, 2007; Berger et al., 2000), their presence enhances the growth prospects of the economy through accelerating productivity (Levine, 2001; Claessens and Van Horen, 2007). Despite the disadvantage foreign banks have relative to their domestic peers due to the non-possession of soft information on local borrowers, this disadvantage may not be germane to their targeted host nation activity, as multinational retail banking is relatively rarely observed (Guillen and Tschoegl, 1999). Foreign bank lending is mainly directed to higher quality borrowers and is cheaper, due to these firms' increased availability of collateral, which serves as a device for the screening process (Sengupta, 2007).

Nevertheless, more recent evidence suggests that foreign banks also lend to small and medium enterprises; however, their share in this type of lending is lower than that of domestic banks in developing countries. Therefore, foreign banks rely on lending technologies such as asset-based lending, leasing and credit scoring and on centralized organizational structures rather than on relationship lending (Berger and Udell, 2006; de la Torre et al., 2010; Beck et al., 2012).

In turn, business regulations are particularly important for a country's institutional and economic development. Indicatively, a stricter and non-competitive business regulatory environment provides the seeds of corruption, as firms attempt to overcome the regulatory burden (Shleifer and Vishny, 1993); this constitutes an important obstacle to economic growth (Djankov et al., 2006).

However, business regulations evolve over time, with forward and backward movements, as countries, particularly developing economies, strive to climb the ladder of international competitiveness and improve the business climate (Braithwaite and Drahos, 2000). International forces, which are composed of globalization and changes in international industrial organization, have been very intense in recent years and have profound implications for regulation and governance (Mayer and Gereffi, 2010). These forces have proven more powerful than potentially opposing domestic ones. The overall effect on business regulations resulted in the worldwide spread of a set of regulatory norms across countries, termed as "globalization of regulation" (Drahos and Braithwaite, 2001). Such globalization does not imply that business regulations have been harmonized across countries or that they move monotonically. On the contrary, it implies that, to an extent, "principles, standards, rules, guidelines and models of regulation have converged", as Braithwaite and Drahos (2000) notably indicate.

2.1. Formulation of the research hypotheses

Given the above, we delineate the potential impact of foreign bank presence on the host country's business regulatory environment.

Foreign banks have the objective of increasing their profits and market shares in the host country. Therefore, these banks are interested in attracting firms with increased collateral values, given their disadvantage in the possession of soft information on local borrowers and better growth prospects. Moreover, foreign banks have increased expertise in international business and are more experienced in collaborating with more competitive clients. Additionally, through their global network, reputation and specialization in services for the more export-oriented local firms, these banks could affect the manner in which local markets operate and compete. These advantages of foreign banks relative to domestic ones, particularly in developing countries, combined with their higher efficiency, may result in the foreign banks' increased interest for a more competitive business environment for the host country that would, in turn, expand their present and future profit opportunities.

Thus, a higher foreign bank presence in the host developing country results in a more internationalized banking system with more sophisticated risk management techniques and more loanable funds available for domestic firms. Moreover, a higher foreign bank presence in a country leads to productivity advances and increased economic growth opportunities for the host country, as well as in improvement in the business conduct. Additionally, an increased foreign presence in the domestic banking system may render more power to foreign banks in favor of economic and regulatory reforms (Claessens and Van Horen, 2014; Levine, 1996).

Given the preceding discussion, the main research hypothesis that we examine in this paper can be formulated as follows:

H1a. The level of foreign bank presence in a country positively affects the efficiency of business regulations over time.

If the foreign bank presence affects the business regulatory environment of the host country, such an effect could be more pronounced the larger the gap in the efficiency of business regulations that foreign banks encounter in the local economy compared to that in the foreign bank's home country. In such a case, a possible "regulatory transfer" channel may be present, in which foreign banks that originate from more efficient regulatory environments serve as sources of institutional diffusion for the host countries. This rationale helps us to more explicitly formulate the following hypothesis:

H1b. The presence of foreign banks from countries with a more efficient business regulatory environment have a more pronounced