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A multivariate analysis of the financial characteristics of foreign and domestic banks in the UK

K. Kosmidou[a, b], F. Pasiouras[a, c], C. Zopounidis[a,*], M. Doumpos[a]

[a] *Financial Engineering Laboratory, Department of Production Engineering and Management, Technical University of Crete, University Campus, 73100 Chania, Greece*
[b] *Department of Economics, University of Crete, University Campus, 74100 Rethymno, Greece*
[c] *Coventry Business School, Coventry University, Priory Street, CV1 5FB Coventry, UK*

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Abstract

For the banking sector in the EU, the UK is one of the most important countries, since over a quarter of all banking assets in the EU are held in the UK and it is the largest single international banking centre, accounting for 20% of the world's cross-border lending. The UK banking sector has traditionally been one of the most open and it is characterized by a rapidly increasing foreign bank presence. Foreign banks account for 55% of the total assets of the UK banking sector. The objective of this paper is to investigate the performance of the banking sector in the UK focusing on the performance of the domestic banks as opposed to the performance of the foreign banks operating in the UK. For this purpose, a multivariate analysis is performed to identify the existing differences between the financial characteristics of domestic and foreign banks, considering profitability, liquidity, risk and efficiency factors. The data sample covers 26 domestic and 32 foreign banks operating in the UK over the period 1998–2001.

Keywords: Bank performance; Logistic regression; Classification

1. Introduction and overview

Until the 1980s the financial industries in most EU member states operated in highly regulated markets, while at the same time, markets for banking services were primarily local in nature. During the late 1980s and early 1990s a restructuring and concentration process took place in a number of EU countries. Moreover, during the last years both developed and developing countries around the world have relaxed restrictions on foreign banking and most of them now allow more foreign banks to undertake more banking-related activities in their domestic banking markets, mainly because of the increasing importance of international trade in goods and financial services. Therefore, over the last decade, the number of banks has fallen in most of the European markets as a result of the concentration, while the number of foreign banks has increased in every banking market over the same period as a result of the internationalization.

Buch and Golder [1] characterize market entry of foreign banks as a "two-edged sword". Indeed, several authors have addressed the potential benefits of foreign bank entry for the domestic economy [2–4]. Foreign competition can enhance the efficiency of the domestic banking sector, improve know-how and technological skills and provide

* Corresponding author. Tel.: +30 28210 37236; fax: +30 28210 69410.
E-mail addresses: kostas@dpem.tuc.gr, kostas@ergasya.tuc.gr (C. Zopounidis).

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access to foreign savings. However, the greater presence of foreign banks has had its critics, since relatively inefficient domestic banks may not be able to withstand competitive pressure, which may even result in bankruptcies. For example, the Businesses Times contented "It could not have been a coincidence that foreign ownership in emerging banking systems increased dramatically during the second half of the 1990s a period that saw many emerging economies battling with the direct impact or the contagion of the Asian Financial crisis" [5]. Engwall et al. [6] study the markets in the Nordic countries and support the Stiglitz and Weiss [7] argument that foreign banks gained entry by accepting worse lending risks.

Dopico and Wilcox [5] measure the extent of foreign banking in over 100 countries. They report the existence of correlations across a wide range of countries between foreign banking and domestic economic, financial and bank regulatory conditions. They also found that foreign banking tended to be more prevalent in countries that were more open to foreign ownership of their banks, more open to the bank's engaging in a wider range of financial services and more open to international trade.

For the banking sector in the EU, the UK is one of the most important countries, since over a quarter of all banking assets in the EU are held in the UK and it is the largest single international banking centre, accounting for 20% of the world's cross-border lending [8]. The UK banking sector has traditionally been one of the most open, and it is characterized by a rapidly increasing foreign bank presence. Data from a survey in 59 countries covered by the 1999 Global Competitiveness Report, published by the World Economic Forum, indicated that the UK was placed third for the degree of competition that domestic banks faced from foreign banks and twelfth for ease of entry of new bank into the domestic banking industry [9]. According to Davies [10] and Strachan [11] foreign banks account for 55% of the total assets of the UK banking sector, with around 70 UK-incorporated subsidiaries of foreign banks or financial institutions, 372 European Economic Area (EEA) Banks, which have passported into the UK under EU directives either through a branch or by providing cross-border services, and around 115 branches of non-EEA banks.

Despite the substantial structural changes and the importance of the UK banking sector, the sector remains relatively underresearched compared to studies in other countries and the limited studies focus on either the financial performance of UK-major banks or Building Societies performance, than other parts of the sector. Therefore, it is interesting to investigate the performance of the banking sector in the UK focusing on the performance of the domestic banks as opposed to the performance of the foreign banks operating in the UK. The purpose of the present paper is to identify the distinguishing financial factors characterizing the operation of domestic and foreign banks in the UK through a multivariate analysis and the development of a specific number of models arising from the combination of the variables. The factors considered in the analysis cover all aspects of financial performance, including profitability, liquidity, risk and efficiency. We test the hypotheses in the light of prior research, which often found that on average foreign banks operating in a developed market were less profit/cost efficient than domestic banks operating in the same market.

A number of studies have compared the efficiency of foreign versus domestic banks in the same nation or nations. Most of these studies, which focused on the US market, employed estimates of either cost or profit efficiency to determine efficiency differences and found foreign banks to be significantly less profit and/or cost efficient than domestic banks [12–17].

Similar results were obtained in studies that examined the Australian market [18,19] and concluded that foreign banks are less efficient than domestic banks in Australia. In addition, Williams [20] found that concentration in the Australian host market reduces profits of the foreign entrants and acts as an effective barrier to entry.

Fewer studies have examined EU markets. Hasan and Lozano-Vivas [21] found that foreign banks in Spain are about equally as profit efficient as domestic banks. Berger et al. [22] estimate cost and profit frontiers to compare the efficiency of foreign and domestic banks in France, Germany, Spain, UK and US. They report that foreign banks on average are less efficient than domestic banks. For the EU nations, in three (France, Germany, UK) of the four markets, cost efficiency as well as profit efficiency are higher on average than foreign banks. In Spain, the fourth EU nation, while domestic banks' cost efficiency is higher than foreign banks' cost efficiency, domestic banks are less profit efficient than foreign banks. After studying German and US markets, Buch and Golder [1] suggested that the comparative advantages of domestic banks in dealing with local customers and assessing credit risk are difficult to overcome for foreign institutions.

Finally, studies that compared the performance of domestic and foreign banks in both developed and developing countries supported the results of previous studies that foreign-owned banks are disadvantaged compared to the domestic-owned banks in developed countries; however, this is not the case in less developed countries [23,24].

The rest of the paper is organized as follows: Section 2 describes the sample data used in this study, the methodology employed as well as the empirical results. Finally, Section 3 discusses the concluding remarks of this study.

2. Data and methodology

2.1. Data

The data set used in this study involves 58 commercial banks operating in the UK over the period 1998–2001. Banks had to meet a number of conditions to be included in the data set. First, they had to be included in the "Institutions In-