International Review of Financial Analysis 30 (2013) 26–35

Contents lists available at ScienceDirect

International Review of Financial Analysis

Foreign bank entry in South East Asia

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ARTICLE INFO

Article history:
Received 3 November 2012
Received in revised form 27 February 2013
Accepted 16 May 2013
Available online 25 May 2013

JEL classification:
F23
G21
G28

Keywords:
Foreign bank entry and motivation
Foreign ownership
South East Asian banking

ABSTRACT

This paper examines the determinants of foreign bank entry in South East Asian countries after significant policy changes following the regional financial crisis in 1997/1998. The results show that manufacturing FDI and bilateral trade exert weak impacts on the decision of entry by foreign banks, providing little evidence for the argument that banks follow their home customers abroad. In contrast, local profit opportunities appear to be the prominent factor attracting foreign bank penetration in South East Asia. The results are robust to different modelling techniques.

1. Introduction

The last two decades have witnessed a tremendous increase in financial services foreign direct investment to various developing economies stimulated by the liberalization of domestic banking markets. In South East Asia, changes in foreign bank participation occurred after the 1997/1998 financial crisis, fostered by the further removal of foreign ownership limits. The relaxation of entry barriers aimed to improve the efficiency of local financial institutions. Banking sector inefficiencies – driven by excess foreign borrowing, low quality credits and sub-standard regulation – have widely been identified as key contributors to the Asian crisis (Corsetti, Pesenti, & Roubini, 1999; Radelet & Sachs, 1998). Given these forces, a better understanding of the underlying motives for foreign bank entry is of interest to policy makers because the reasons for entry may determine the form of physical existence in the destination market which, in turn, can affect local banking sectors differently.[1]

Theory suggests a wide range of motives for foreign bank expansion and the empirical literature has sought to identify such factors.[2] An often cited motivation for financial FDI relates to customer-following which suggests that banks follow their home (usually corporate) customers to take advantage of and to retain pre-existing bank–customer relationships. Another main motivation focuses on performance improvements (or profit-exploitation), namely banks are motivated by the business opportunities found abroad. Stemming from the second view, theory further assumes that the motivations for banks to expand overseas may depend on the level of economic development in the host countries. Accordingly, it has been suggested that in developing countries, foreign banks are more likely to be attracted by profit opportunities (Clarke, Cull, Peria, & Sanchez, 2003, p. 36) due to their underdeveloped systems, lower levels of bank efficiency and relatively high demand for financial services. According to one survey, expected profit margins appear to be the main motivation for banks to expand their services in emerging economies, whereas other factors appear of limited importance (Bank for International Settlements, 2004, p. 28).

Empirical research investigating the motivation for foreign bank entry has been conducted since the early 1980s and early studies mainly

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[1] For example, if foreign banks enter to mainly serve their domestic multinational clients, one would expect them to primarily conduct wholesale services. In this case, they would prefer to establish foreign branches. Alternatively, if banks enter to mainly exploit the growing individual demands of highly populated nations and to sell their superior banking products and business management, one would expect these banks to serve the retail banking market segments. Subsequently, they would prefer to set up subsidiaries or acquire local banks if regulation is open for doing so. The presence of foreign bank branches tends to affect corporate market niches while that of subsidiaries is more likely to influence retail segments. Relevant empirical research shows that, in order to overcome the disadvantages of information asymmetries, foreign banks prefer to enter through acquisition (Lehner, 2009) which hinders competition (Lozano-Vivas & Weill, 2012) while entry through greenfield investment stimulates competition (Claeys & Hainz, in press) and improves efficiency (Lozano-Vivas & Weill, 2012) in local banking markets.

[2] See Buch and DeLong (2009) and Herrero and Simon (2003) for excellent reviews.

1057-5219/$ – see front matter
http://dx.doi.org/10.1016/j.irfa.2013.05.004

explore bank expansion into developed banking systems of North America (Goldberg & Grosse, 1994; Goldberg & Saunders, 1981a; Grosse & Goldberg, 1991; Hultman & McGee, 1989) and Western Europe (Buch, 2000; Fisher & Molyneux, 1996; Magri, Mori, & Rossi, 2005; Mutinelli & Piscitello, 2001; Wezel, 2004; Yamori, 1998). More recently, attention has focused on foreign bank entry in emerging markets (see for example, Claessens & Van Horen, 2012b). This literature examines a number of themes including: how foreign banks impact domestic banking markets (Claessens, Demirgüc-Kunt, & Huizinga, 2001; Jeon, Olivero, & Wu, 2011; Lensink & Hermes, 2004; Manlagñit, 2011; Unite & Sullivan, 2003); how they perform compared to domestic rivals (Berger, Hasan, & Zhou, 2009; Chen & Liao, 2011; Havrylchyk & Jurzyk, 2011; Micco, Panizza, & Yanez, 2007; Okuda & Rungsomboon, 2006); and, the influence of different modes of entry (Cerutti, Dell'Ariccia, & Peria, 2007; Lehner, 2009; Li, Zeng, & Zhang, 2013). There still remains, however, a somewhat limited literature directly investigating motivations for foreign bank entry in emerging economies and particularly in Asia.

The objective of the present paper, therefore, is to explain the motivation for foreign bank entry in South East Asian economies. By including proxies for customer-following behaviour and local profit opportunities in our model we examine whether customer-following or profit-seeking opportunities are the main motive for foreign bank entry in South East Asia between 1998 and 2004. There are three main reasons why South East Asia is selected as a region for study. First, after the Asian financial crisis of 1997/1998, policies towards foreign bank entry changed markedly, with a general liberalization aimed at promoting efficiency and competition in domestic banking systems. In Thailand, for instance, a 30% cap on foreign ownership was increased to 100% in 1997, and in Indonesia the limit was increased from 45% (which had been on place since 1992) to 99% by 1999 (Table 2). Second, these countries all had underdeveloped bank-based systems with relatively large populations with potential for substantial increases in demand for financial services. Finally, the region attracted large manufacturing FDI inflows associated with successful export-led growth models in the run-up to the crisis (Economist, 2007). The aforementioned factors highlight why this region is of particular interest to test customer-following and profit-seeking motives for foreign bank expansion in the region.

The paper is structured as follows. Section 2 outlines the theoretical motivations as to why foreign banks expand overseas. Section 3 presents the methodology while Section 4 discusses the data. Section 5 reports the results from different estimates of the determinants of foreign bank participation and finally, the conclusion follows in Section 6.

2. Motivations for foreign bank entry

As mentioned, our study investigates two main motives concerning why banks establish a physical presence overseas.

2.1. Banks follow their clients abroad

The customer-following view suggests that banks move overseas to serve their home customers to ensure the continuing relationship with parent corporations at home by preventing foreign corporate affiliates from turning to new banks (which could be those from the same home countries having offices in foreign host countries) (Nigh, Cho, & Krishnan, 1986, p. 60). Secondly, thanks to the advantage in their pre-existing relationship with clients in home countries, banks have good knowledge of their customers' businesses, which helps to lower service charges and risk. Thirdly, on the side of clients, manufacturing firms may prefer to maintain credit relationships with a selected group of financial firms in order to avoid costs resulting from providing corporate information to new banking partners (Lewis, 1991, p. 133).

A substantial number of studies investigate foreign bank presence from either a single home or host country perspective. Studies on North America suggest that foreign banks enter the US (Goldberg & Grosse, 1994; Goldberg & Saunders, 1981a; Grosse & Goldberg, 1991; Hultman & McGee, 1989) or US banks expand overseas (Goldberg & Johnson, 1990; Miller & Parkhe, 1998 [3]; Nigh et al., 1986; Sagari, 1992) in order to serve their home clients, measured by non-bank FDI and/or trading volume. Studies on countries outside the US, mainly in Europe, also reveal relatively common evidence of customer following motives (Buch, 2000; Fisher & Molyneux, 1996[4]; Magri et al., 2005[5]; Mutinelli & Piscitello, 2001; Wezel, 2004; Yamori, 1998).

Another range of studies consider similar arguments from a multi-home and multi-host country perspective although the findings tend to be inconclusive. Brealey and Kaplanis (1996), for instance, analyse a sample of the world's 1,000 largest banks by assets size (including 37 home and 82 host nations for 1992) and show that foreign bank presence is determined by the overseas location of the non-bank sector. In contrast, Moshirian and Van der Laan (1998) find that non-bank FDI is negatively and significantly related to foreign presence of banks incorporated in the US, the UK and Germany, while host country's real national income appears to be one of the major determinants of foreign bank assets from these countries.

2.2. Banks are attracted by local profit opportunities

On the other hand, the profit-exploiting view suggests that banks expand abroad to exploit business opportunities in local markets. Scattered evidence seems to suggest that there is motivation for banks to go abroad other than following their clients. Observations of US bank expansion overseas during the late 1960s and the early 1970s revealed that this appears to parallel the expansion of US non-financial firms to the same nations (Aliber, 1984). However, in the late 1970s and early 1980s, banks headquartered in many Western European nations and Japan expanded to the US and this did not appear to be reflected in FDI or trade flows. In addition, Fisher and Molyneux (1996, p. 274) also noted that while FDI into the UK was most substantial between 1986 and 1989, this was a period where “foreign bank presence in London was slowing”. Besides, the growth of foreign banks in offshore centres such as the Bahamas and the Cayman Islands also provides the typical counter-example of how local opportunities attract the foreign location choice by banks (Lewis & Davis, 1987, p. 238). Furthermore, Seth, Nolle, and Mohanty (1998) compared the amount of funds received by non-financial corporations to the amount of loans granted by foreign banking institutions in the US and found that the lending volume granted by foreign banks in the US was higher than the amount of loans received by US-based foreign firms. This implied that customer-following reasons were perhaps not the main reason for banks to locate overseas.

Empirical studies that try to examine profit opportunities are relatively limited. Goldberg and Saunders (1981b) related the assets of different types of foreign bank organisational forms in the US to lagged interest margin, the rate of domestic investment (as a proxy for profits) and imports (as a proxy for customer-following motives). They find that local opportunities, measured by the level of domestic investment, are important in attracting foreign bank presence while customer-following motives appear only important for bank agencies only. Nigh et al. (1986), in contrast, find that local market opportunities exert no significant impact on the decision of US banks to go abroad while the overseas presence of US firms is significant. However, Nigh et al. (1986) note the weak proxy they use to measure the local market opportunity — the amount of manufacturing production in the host country.

[3] In this study, bilateral trade is found to have a negative (and significant) relationship with the presence of US banks overseas.

[4] Inward FDI into the UK is not statistically significant in explaining foreign banking activity in London. In contrast, outward FDI from the UK to the home nations is significantly and positively related to foreign banking in London (measured by the number of employees).

[5] Non-bank FDI had no impact on foreign bank's decision to locate in the Italian market. This result is in accord with the finding by Fisher and Molyneux (1996).