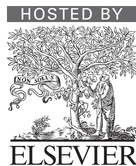

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Banking sector globalization and bank performance: A comparative analysis of low income countries with emerging markets and advanced economies

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Abstract

A key feature of financial services liberalization is the increasing presence of foreign banks in a nation. This study examines the impact of banking sector globalization on bank profits and cost efficiency by using a panel of 169 nations spanning 1998–2013. Employing both fixed-effects and GMM estimations, and including banking-industry and macroeconomic controls, I find greater banking-sector globalization to reduce both profits and cost inefficiency, thereby reflecting increased competitiveness and informational asymmetries in host markets, as well as assimilation of better technology, managerial practices by domestic banks. The results are further examined for nations across different levels of economic development and with different degrees of foreign bank presence. Only in emerging markets and in nations with more than 50% foreign banks, greater banking sector globalization positively affects profits. From a policy perspective, the findings call for banking regulatory authorities to implement polices to reduce informational asymmetries in host markets.
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1. Introduction

The banking industry was in the eye of the recent global financial crisis (henceforth GFC) where several nations witnessed unprecedented declines in banks' earnings. Such deteriorating bank performance is often a harbinger of bank failures and banking crises, along with their subsequent adverse consequences on the overall economy. Therefore, the determinants of bank performance have attracted the interest of academic research as well as of bank management, financial markets and bank supervisors, as a soundly performing banking industry is better able to withstand negative shocks and contribute to the stability of the financial system.

The last two decades have seen a rapid increase in the process of banking-sector globalization. However, arguments supporting a policy of openness toward the banking industry in a host nation are far from universally accepted. In the aftermath of the recent global financial crisis, there has been considerable academic focus and policy attention on the roles of foreign banks in creating economic vulnerability in host countries (Cetorilli and Goldberg, 2012a,b; De Haas and Van Horen, 2011).[1]

In the backdrop of this financial landscape, the present study examines the impact of the banking sector globalization on two key facets of bank performance – profitability and cost efficiency by using a panel dataset of 169 nations encapsulating the most updated time period 1998–2013. The past two decades is marked by increase in financial globalization, especially in low income countries and emerging markets. One aspect of such liberalization is the introduction of regulatory reforms in the banking sector as well as participation in a wider range of financial services by banks (see Klomp and Haan, 2015 on the impact of bank regulation on industry risk). Yet the recent global financial crisis has not left the banking system unscathed in almost

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[1] With economic downturn in their home nation, foreign banks may receive less financial support from their parent banks. Hence, this is reflected in their own reduced lending operations in the host nation, causing the domestic banking industry to suffer as well.

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any nation. A conspicuous feature of the banking industry in most nations was declining bank profits. This has sparked a burgeoning body of literature in scrutinizing the determinants of bank profitability. Such studies have ranged from individual country specific studies like Athanasoglou et al. (2008) on Greece, Dietrich and Wanzenried (2011) on Switzerland, Garcia-Herrero et al. (2009) on China; Sufian and Habibullah (2012) on Indonesia; to multi-country panel studies like that of Dietrich and Wanzenried (2014) for low-, middle-, and high-income countries; Brissimis et al. (2008), Goddard et al. (2013), Pasiouras and Kosmidou (2007), Staikouras and Wood (2004) for several EU nations. In this context, the present study makes three key contributions to the literature. First, using different measures of banking sector globalization, I examine their impact on bank performance. Secondly, I scrutinize not only the macroeconomic and external determinants of bank performance but also the banking-industry specific factors. Thirdly, I provide a comparative perspective by examining the results for low income countries (LICs) with emerging and developing market economies (EMs) and advanced economies (AEs).[2] I also cover the widest possible range of nations for the period 1998–2013.

From the perspective of development finance, in LICs and to an extent in EMs, there are significant informational asymmetries that increase the cost of acquiring soft information by foreign banks, on the basis of which a large share of potential borrowers are identified. Thus, the understanding the implication of banking sector globalization on host nations bank performance is important for the development of the domestic banking industry. From the host nation's policymakers point of view, economic success of any nation intrinsically hinges on the tradeoff between external policy choices and their internal consequences. One such external policy choice, very relevant in LICs and EMs, is the extent of banking sector openness. Hence, in guiding economic policy, the findings of the analysis will shed light on regulatory measures for central bankers and governments, but also for adequate risk management by banks.

The benefits and costs of banking sector globalization have been hotly debated in the media, policy forums, and academic conferences. Arguments in favor of opening a nation's banking sector to foreign ownership are made under several premises. First, some contend that a foreign bank presence increases the amount of funding available to domestic projects by facilitating inflows of capital. Such a presence may also increase the stability of available lending to the host nation by diversifying funding bases, and hence increasing the overall supply of domestic credit. Secondly, others argue that foreign banks improve the quality, pricing, and availability of financial services, both directly as providers of such enhanced services and indirectly through competition with domestic financial institutions. Thirdly, foreign bank presence is said to improve financial system infrastructure – including accounting, transparency, and financial regulation – and stimulate the increased presence of supporting agents such as ratings agencies, auditors, and credit bureaus. Also their presence might enhance the ability of regulatory institutions to measure and manage risk effectively. Foreign banks are backed by their parent banks, so may be perceived as safer than domestic counterparts, especially in times of economic crisis. Last but not least, foreign banks may be less susceptible to political pressures and less inclined to lend to connected parties. These forces imply positive economic effects of a foreign bank presence in a host nation (see, Dages et al., 2000; Levine, 1996, among others).

In rebuttal to these points those opposed to foreign bank participation argue that because foreign banks have weaker ties with host markets and have more alternative business opportunities than domestic banks, they are more likely to be fickle lenders (Cull and Peria, 2007). There is also the potential that they could import shocks from their home countries. Other economists have argued that foreign-owned banks will in fact decrease the stability of bank credit provision by withdrawing more rapidly from local markets in the face of a crisis either in the host or home country (Peek and Rosengren, 2000). Yet others argue that foreign banks "cherry pick" the most lucrative domestic markets or customers, leaving the less competitive domestic institutions to serve other, riskier customers and increasing the risk borne by domestic institutions. Moreover, independent of the effect on aggregate credit, the distribution of credit may be affected, resulting in redistribution and potential crowding out of some segments of local borrowers. This may lead to rising income inequality or higher rural–urban divide (see Berger et al., 2005; Dages et al., 2000; Detragiache et al., 2008).

The effect of foreign banks on profits and costs in host markets are also theoretically debatable. On the one hand, foreign bank presence might lead to higher profitability as foreign bank's technological edge is relatively strong, and these often internationally well-known banks might also have lower costs of raising funding. The benefits of newer technology can spill-over to domestic banks leading to higher profits for the entire banking industry. On the other hand, foreign banks might be less profitable as they may not be strong enough to overcome informational disadvantages (Demirguc-Kunt and Huizinga, 1999). Their presence will also increase competition for domestic banks, thereby reducing profits for all.

Foreign bank entry is also expected to improve cost efficiency in host markets. These banks typically bring new and better skills, management techniques, training procedures and technology, that positively spill-over to the domestic banking industry. Thus, foreign banks may boost efficiency by stimulating competition on the host-nation's banking industry that will put downward pressure on overhead expenses and hence improve cost efficiency (Demirguc-Kunt et al., 1998). Any associated improvements in managerial efficiency and organizational structure with increase in foreign bank presence is expected to result in a decline in operating expenses (Claessens et al., 2001). Similarly, Berger and Hannan (1998) discuss the possibility that with an increase in foreign bank entry, domestic bank managers may be forced to give up their sheltered 'quiet life' and exert greater focus on cost efficiency. In contrast, foreign bank entry might spark better monitoring and supervision on the part of domestic banks as well. If monitoring costs are

[2] These nations are categorized under these categories following the World Economic Outlook (2012) of the IMF. Appendix A provides the complete list of nations.

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