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Bank reforms, foreign ownership, and financial stability

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A B S T R A C T

Numerous studies have focused on foreign ownership of banks, but instead of linkages to financial stability, they typically analyzed other issues and used country-level data. This article fills the gap in the literature by applying the GMM techniques on dynamic panels using bank-level data for Asian countries to investigate the impact of foreign ownership on financial stability, as well as whether the relation between foreign ownership and stability changes under different conditions of bank reforms in the host country. Specifically, we reach five conclusions. First, the existence of *the home field advantage hypothesis* is supported; nevertheless, when considering the effects of bank reforms, *the global advantage hypothesis* holds. Second, an inverse U-shaped relation between foreign ownership and stability is supported. Third, a higher degree of credit control liberalization mitigates the negative effect of foreign ownership on stability. Fourth, liberalization of interest rate control and banking supervision do enhance stability. Fifth and finally, we confirm a significantly negative relation between an explicit deposit and stability.

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1. Introduction

Over the past few decades, many countries have liberalized their financial policies and begun to encourage the entry of foreign banks into the domestic banking system. Despite theoretical arguments, empirical evidence regarding the relation between foreign bank participation/presence and domestic bank behavior is still unclear to date. To the best of our knowledge, no extant studies consider whether the foreign ownership-stability relation varies across banks through country-specific characteristics, nor do they consider the role of financial reforms in Asia's banking industry.

Asia's banking industry is interesting since it has carried out financial liberalization quite dynamically over the past two decades. Originally, the low participation rate of foreign banks in Asia is largely a legacy of strict regulations on foreign bank entry and operation by governments in Asia. Even in countries where the new entry of foreign banks was legally permitted, it was prevented in practice (Pigott, 1986). However, during the collapse of the region's banking sectors and overall economies in the 1997 Asia crisis, the domestic investment partners were unable to participate in the much-needed recapitalization of banks. In response, Indonesia's government raised the limit on the foreign ownership of joint-venture banks from 85% to 99%, while South Korea in 1998 allowed 100% foreign ownership of domestic financial institutions (Cho, 2002). In Malaysia, foreign banks could originally only make loans in partnership with domestic banks, and foreign ownership of joint venture banks was limited to 30%. However, between 1995 and 1996, several 100% foreign-owned banks were established. Thailand's government relaxed its foreign ownership restrictions, allowing foreign investors to hold a majority stake in Thai financial institutions for up to ten years. As a result, at the end of 2001 there were four majority foreign-owned joint venture banks operating there (Montgomery, 2003). The Philippines passed the General Banking Law in 2000, replacing the 52-year old General Banking Act. The new law allows a foreign bank to acquire up to 100% of the voting stock of only one bank, but only within seven years from the effectiveness of this law (Manlagñit, 2011).

China designated that from 1999, small business loans could carry a premium of up to 30% (50% for rural credit cooperation) over the central bank rate. In 2002, China's State Council announced a policy of liberalizing all interest rates. Since 2003, banks and customers have been able to negotiate foreign currency deposit rates. By 2004, there were roughly 204 foreign bank subsidiaries, which are permitted to provide nation-wide foreign exchange facilities to foreigners and Chinese citizens (Fu and Heffernan, 2009).

Findings from theoretical and empirical studies on the effect of foreign ownership on domestic bank performances are mixed, given the complexity. Berger et al. (2000b) differentiate *global advantage* and *home field advantage hypotheses*. *The global advantage hypothesis* states that foreign banks might benefit from competitive advantages relative to their domestically-owned peers. Foreign-owned banks use more advanced technologies due to stiff home market competition. Foreign banks might also be more competitive when compared to domestic banks due to an active market for corporate control in the home country, and because they have access to an educated labor force that is able to adopt new technologies. However, Detragiache et al. (2008) demonstrate a theoretical model, showing that monitoring soft information customers at domestic banks are better than it at foreign banks; foreign bank entry may hurt bank customers and worsen their welfare.

Many studies using cross-country data empirically compare the performance of foreign banks with domestic banks and find that foreign banks operating in developing countries are more efficient and competitive than domestic banks (e.g. Claessens et al., 2001). Majnoni et al. (2003) and Sabi (1996) conclude that foreign banks in Hungary are more profitable than domestic banks. Using Polish data, Havrylchyk (2006) suggests that foreign banks exhibit higher efficiency than their domestic peers, however, foreign banks that have acquired domestic banks do not appear to have enhanced their efficiency. Havrylchyk (2006) gives support to *the hypothesis of the limited global advantage*. Crystal et al. (2002) analyze the differences in stability between domestic and foreign banks in Latin American countries. Foreign banks tend to have a more aggressive response to asset deterioration and a greater ability to absorb losses measured as risk-weighted capital ratios that promote stability in the banking system.

The home field advantage hypothesis predicts that foreign banks are at a disadvantage when compared to domestic banks. Foreign-controlled banks are assumed to perform less well than

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