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Foreign entry and the Turkish banking system in 2000s

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ABSTRACT

In recent decades, the role of foreign ownership in banking sectors, and especially the developing ones has become a frequently investigated topic among finance scholars. Similar to many other developing countries seeking to attract foreign direct investments, Turkey has experienced a great increase in the number of foreign-owned banks in the sector following the 2000 and 2001 economic and financial crises. Using panel data regression analysis for a sample of 31 deposit banks operating in Turkey, for the period 2002–2012, we find that foreign ownership has a negative and statistically significant impact on accounting profits, proxied by the ratio of earnings before taxes to total assets. However, contrary to expectations, three other dependent variables representing interest rate spreads, non-lending activities and short term risk, were not found to be significantly associated with foreign ownership.

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1. Introduction

The past three decades have experienced a revival of international banking as a result of the expansion of international financial integration. Therefore, foreign ownership has increased dramatically in the banking sectors in many countries. As a result, finance scholars, practitioners and policy makers

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have become greatly interested in the functioning, efficiency and performance of foreign banks in their host countries, compared to their domestic competitors. The existing literature provides conflicting results about the impact of foreign entry on banking system(s), and these conflicting results are discussed mostly in terms of differences between home and host countries. These differences have been attributed generally to national variations in economic, political, institutional and regulatory characteristics. Based on the evidence provided by Claessens, Demirgüç-Kunt, and Huizinga (2001), it can be postulated that foreign banks tend to have higher interest margins, profitability and tax payments than domestic banks in developing countries, while the opposite is true in developed countries.

Besides studies focusing on the comparison of domestic and foreign banks, and those concentrating on the performance determinants of foreign-owned banks, the literature review provides several examples of research investigating the costs and benefits of opening the financial sector to foreign ownership in a developing country. For instance, capital injection to the host country can be considered as one of the major benefits (Crystal, Dages, & Goldberg, 2002; Lardy, 2001). Moreover, foreign bank entry may help to improve the host country's access to international capital (Claessens et al., 2001). Also, enhanced competition following foreign bank entry, may improve the efficiency of domestic banks (Claessens et al., 2001; Lardy, 2001; Lensink & Hermes, 2004). Furthermore, foreign banks may provide domestic banks with better technological facilities, which enhance risk management and internal controls (Crystal et al., 2002), and the existence of foreign banks may stimulate the development of the bank supervisory and legal framework in the host country. Finally, the presence of foreign banks may increase financial system diversity in terms of products and participants (BIS, 2005). On the negative side, foreign bank entry may foster speculative bubbles in domestic markets, which may result in financial crises, as in the case of Thailand in 1997. One of the main reasons was the speculative operations of Japanese multinational banks in real estate in Thailand in the early 1990s, which were designed to recover the losses incurred in Japan in the late 1980s. Another danger is that actions of multinational banks may oblige domestic banks to engage in speculative operations to remain competitive, causing domestic financial systems to become destabilized (Weller & Hersh, 2002).

Within this framework, we investigate how foreign bank entry and changes in foreign ownership affects the operations, performance and risk of the Turkish banking sector in 2000s. The motivation of this paper stems from Turkish banking system developments over the last decade, and is threefold:

Firstly, the Turkish banking sector is a prominent setting for this study due to the change in not only regulatory, but also ownership structures of Turkish banking, subsequent to severe financial and economic crises in 2000 and 2001. Following a three-year IMF stand-by agreement signed by Turkish government in December 1999, the structural problems in Turkish banking system and restructuring of banking sector have emerged among the IMF priorities. Consequently, a new banking law has combined the public units responsible for monitoring and supervising the banking sector under the structure of an autonomous agency, namely Banking Regulation and Supervision Agency (BRSA became operational on August 2000). A relatively more stable economic and financial environment emerged due to this IMF-led economic program focusing not only on banking sector reforms, but also on overcoming chronic high inflation of the 1990s and macroeconomic instability. In such an environment, the Turkish banking sector has been attracting considerable attention of foreign investors. The market share, in terms of total assets, of foreign owners in the Turkish banking market increased to almost 14% in 2012 from about 3% in 2002.[1] At the end of 2012, 16 of 32 deposit banks were foreign-owned.[2] Thus, the decade 2002–2012, covering important changes in banking and economic environment, is worthy of analysis.

The second motivation for the study concerns the growth in demand for financial services in Turkey. Turkey's population grew about 12% between 2002 and 2012, and as end of 2012,[3] 67% of population is under 40 years old. Furthermore, per capita gross domestic product in Turkey is increased from 3492 USD in 2002 to 10459 USD in 2012 and this has led to the growth of the Turkish middle class, and standards of living. This demographic and economic situation created particularly fertile ground

[1] *Source*: ⟨http://www.tbb.org.tr/tr/banka-ve-sektor-bilgileri/banka-bilgileri/tarihsel-bilgiler/68⟩
[2] *Source*: ⟨http://www.tbb.org.tr/tr/banka-ve-sektor-bilgileri/banka-bilgileri/tarihsel-bilgiler/68⟩
[3] *Source*: ⟨http://www.nvi.gov.tr/Hizmetler/Istatistikler,Ikamet_Istatistigi.html⟩

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