Foreign bank entry and performance with a focus on Central and Eastern Europe
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Introduction

One of the biggest changes brought about by international deregulation and harmonization of the financial sector has been the rise in foreign banking. Foreign ownership of banks is particularly important in the Caribbean, Central and Eastern Europe, Central Asia, Latin America and Sub-Saharan Africa. This book aims to extend the evidence on foreign banking by examining three research questions: (i) What do foreign banks do in their role as intermediaries? (ii) Why does a bank start foreign operations and does its entry motive affect its entry mode? (iii) Are profitability and efficiency of a bank affected by foreign ownership? In addressing the first two questions, I specifically look at foreign bank behaviour in Central and Eastern Europe. Since 1989, many of the former centrally planned economies in Central and Eastern Europe are returning to a market based economy. During this transition, foreign banks have gradually received the opportunity to establish branches and subsidiaries in Central and Eastern Europe. Now, the importance of foreign banks in Central and Eastern Europe exceeds that in most countries worldwide. In 2006, foreign banks in the new EU member states own 82 percent of bank assets, compared with 5 percent in 1995. The remainder of this introduction has a dual purpose: it explains the book’s approach and the organization of the chapters; and it identifies some important topics that receive little attention in the book.

Foreign banks’ lending behaviour

The study of foreign owned banks has attracted wide attention in recent years from the academic world. Increasingly, the role of foreign banks in (the stability) of credit supply to the private sector is being studied as foreign banks may have more troubles in assessing the emerging private sector, notably small and medium-sized enterprises than domestic owned banks. In a recent study, Detragiache et al. (2006) find that in poor countries, a stronger foreign bank presence is robustly associated with less credit to the private sector. In addition, in countries with more foreign bank penetration, credit growth is slower and there is less access to credit. Similarly, both Berger et al. (2001) and Clarke et al. (2005) find that foreign banks in Argentina, Chile, Colombia and Peru have problems supplying funds to small businesses. Once established abroad, foreign banks focus their activities mainly on large enterprises. Stanley et al. (1993a) find that in the US, foreign-owned banks commit a significantly larger portion of their loanable funds to business lending than domestic banks. Regarding the distribution of business loans between domestic and foreign borrowers in the US, large foreign banks tend to shift over time in favour of domestic business loans (Stanley et al. 1993b). Seth et al. (1998) find that foreign-owned banks first and foremost lend to borrowers other than customers from the home nation. This is in line with a theoretical paper by Du (2003) who argues that multinational enterprises prefer their foreign subsidiaries
being co-financed with local participation as it hardens the budget constraint because local banks have more strength in seizing firm assets in liquidation.

A related topic is the impact of foreign bank entry on the stability of credit supply. According to a 2000 IMF report, it is still unclear whether a greater foreign bank presence contributes to a less volatile supply of credit in emerging economies, especially during adverse economic times. Indeed, Jeon et al. (2006) find that foreign banks supplied more foreign currency loans than domestic banks in pre-crisis Korea for a given home-country growth rate, than in post-crisis Korea. Peek and Rosengren (2000a) find that the collapse of the Japanese equity and real estate markets and the subsequent banking crisis in Japan had an impact in the US, as Japanese bank subsidiaries in the US reduced their lending in response to the problems in Japan. Similarly, Martinez Peria et al. (2002) find evidence of foreign banks transmitting home country shocks to Latin America and Peek and Rosengren (2000b) show that cross-border lending did in some cases retrench during economic slowdowns in Latin America. However, Dages et al. (2000) and Crystal et al. (2002) show that foreign banks that have been present in Latin America for a relatively long time exhibit stronger and less volatile loan growth than domestic banks. Likewise, Peek and Rosengren (2000b) and Martinez Peria et al. (2002) find that foreign bank subsidiaries did not reduce their credit supply during adverse economic times in the host country.

**Why do banks go abroad?**

A second branch of foreign banking examines the relevance of foreign banks’ reasons for entry to their nature of financial intermediation. There are various motives for banks to go abroad. One of the main reasons is that foreign banks follow their customers (Goldberg and Saunders, 1981; Brealey and Kaplanis, 1996; Konopielko, 1999; Buch, 2000; Moshirian, 2001; Green et al. 2004; Williams 2002). A second reason why a bank might go abroad is the attractiveness of the host market. The market of the host country may offer new opportunities to make money, depending on the characteristics of the market (like size, stability of the country and features of the local banking sector). A number of recent studies offer support for the view that profitable opportunities in host countries drive foreign bank entry. For example, Claessens et al. (2000) model foreign bank presence in 80 countries, including some transition countries, from 1988-95 and find that foreign banks are attracted to markets with low taxes and high per capita income. In addition to control for the degree of economic integration between countries (non-financial FDI, bilateral trade, and geographical distance) and regulatory restrictions, they include variables that measure the prospects for economic growth and the competitiveness of the banking sector of the host countries. Likewise, Papi and Revoltella (1999) find in their study

\[\text{1} \quad \text{However, often it is unclear to what extent there is also a causal relationship, as causation may run from FDI of banks to FDI in the non-financial sectors. It is also possible that some omitted factor(s) is (are) driving FDI in both sectors.}\]
on 9 transition countries that various variables that proxy the attractiveness of the new market are positively and significantly correlated with FDI initiatives by foreign banks. Similar results are reported by Mathieson and Roldes (2001) in their study on 15 emerging countries, including the Czech Republic, Hungary and Poland. Variables that are significant in this study include the rate of return on equity, non-performing loans and banking crises. Again, for some of these variables causality may go in both directions. For instance, a foreign bank may be attracted to a country with an efficient banking system, but the entry of foreign banks may enhance the overall efficiency of the banking sector. A third consideration for foreign bank entry is host country regulation, which generally limits competition and protects inefficient domestic banks (Clarke et al. 2003). Foccarelli and Pozzolo (2001) find that foreign banks prefer to invest in countries with fewer regulatory restrictions. However, this study does not deal with transition countries. Lensink and De Haan (2002) provide strong evidence that foreign bank entry in transition countries positively responds to economic reform measures. Moreover, they find that reforms significantly affect foreign bank entry via the efficiency of the financial sector and by stimulating domestic investment. Papi and Revoltella (2000) find that the attitude of the authorities in the host country concerning entry of foreign banks is a significant determinant of FDI initiatives of banks in contrast to bank taxes.

The activities of foreign banks are also dependent on the mode of entry. A takeover goes along with the acquisition of the existing client base, including its retail banking activities. Along with the greenfield investment goes the ability to build up the activities from scratch. The bank does not have to cope with the potential of a bad loans portfolio from past activities. Regulation may also affect the activities of foreign banks. In Slovenia, for example, liberalization of foreign borrowing by residents and the abolition of interest rate ceilings on deposits have created a more competitive environment, but only since 1999 (EBRD, 2001). Likewise, Hungary initially did not permit banks to provide financial and insurance services. Changed legislation in 1999 resulted in a movement towards a model of universal banking (ECB, 2001).

Ownership and performance

A third branch of foreign banking literature is concerned with the effect of foreign ownership on bank performance. According to Claessens et al. (2001), foreign banks are more profitable and efficient than domestic banks in developing countries, while in developed countries domestic banks are more profitable and efficient than foreign banks. These differences can reflect a differential impact of informational (dis)advantages, customer bases, bank procedures as well as different relevant regulatory and tax regimes. In contrast, DeYoung and Nolle (1996) and Berger et al. (2000) find that foreign banks are less efficient than host nation banks in developed nations. Berger, Dai, Ongena and Smith (2003) find that foreign affiliates of multinational firms use host nation banks for cash management services. This choice appears to affect the geographic scope and size of the chosen bank, the so-called bank reach.
Furthermore, they find that legal and financial development of the host nation affects both bank nationality and bank reach. Focarelli and Pozzolo (2001) and Buch and DeLong (2004) analyse cross-border M&A in the banking industry. These, in general, appear to be relatively unprofitable (see also Berger et al., 2000; DeLong, 2001).

Few studies have been published that focus on transition countries only. Kraft and Tirtiroglu (1998) have studied X-efficiency and scale-efficiencies for both old and new (state and private) banks in Croatia. New banks (i.e. foreign banks) are shown to be more X-inefficient and more scale-inefficient than either old privatised banks or old state banks. However, new private banks are highly profitable. According to these authors, this abnormal situation has been the result of free-riding opportunities created by distressed borrowers, limited competition and start-up difficulties of the new banks. Grigorian and Manole (2002) have analysed 17 transition economies over the 1995-1998 period and find that foreign ownership with controlling power and enterprise restructuring enhances commercial bank efficiency. Weill (2003) has studied banks in the Czech Republic and Poland using the stochastic frontier approach to compute cost efficiency scores. Also this study reports evidence that foreign banks are more efficient than domestic banks. Weill (2003) also concludes that the advantage of foreign banks does not result from differences in the scale of operations or the structure of activities. Yildirim and Philippatos (2003) study twelve transition economies of Central and Eastern Europe over the period 1993-2000 and find that foreign banks are more cost efficient but less profit efficient relative to domestically owned private banks and state-owned banks. Bonin et al. (2003) have used data from 1996 to 2000 for eleven transition countries to investigate the effect of foreign ownership on the banking sectors in general and bank efficiency in particular. Using stochastic frontier estimation procedures, they compute profit and cost efficiency scores. Their results indicate that banking sectors in these countries became more efficient and more competitive toward the end of the 1990s. They also find that government banks are less efficient than their private counterparts and that majority foreign ownership generates higher efficiency scores. Moreover, they report that banks with participation by international institutional investors, about 10 per cent of their observations, earn higher returns on assets and are more efficient by the profit measure; however, these banks are not significantly more cost efficient. A recent paper by Green et al. (2004) focuses on economies of economies of scale and scope in transition countries, distinguishing between domestic and foreign banks. Their conclusion is somewhat out of line with those of most previous studies on foreign bank entry. Using a panel of 273 foreign and domestic banks located in nine European transition economies (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania) during 1995 – 1999, they reject the hypothesis that foreign banks are more efficient than domestic banks in these economies. They also find that foreign ownership is hardly an important factor in reducing the banks total costs. Havrylchyk (2006) has investigated the efficiency of the Polish banking industry between 1998-2000, using data envelopment analysis (DEA), which allows distinguishing between cost, allocative, technical, and scale efficiency.
This author concludes that bank efficiency has not improved during the analysed years. Foreign banks were found to be more efficient than their domestically owned counterparts. Loan portfolio quality, higher productivity of labour, and market power have the largest impact on efficiency.

**Externalities of foreign bank presence**

A final strand in the literature highlights that the entrance of foreign bank ownership may also have various positive externalities on the development of the domestic financial system. First, foreign banks will help improve the quality, pricing, and availability of financial services, both directly as providers of these services and indirectly through increased competition. The ECB (2002) notes that foreign investors bring capital and know-how and foster the implementation of best practices of the domestic banking system. In addition, foreign banks are often seen as improving the allocation of credit since they have more sophisticated systems for evaluating and pricing of risks. They are also more experienced in the use of derivative products (Mathieson and Roldos, 2001). Also the likely improvement of human capital due to foreign bank presence will be beneficial, because the skills required for the banking business were scarce during the first years of transition. Second, entry of foreign banks may reduce the market power of domestic banks, which was important as at the beginning of transition the creation of a two-tier banking system produced an oligopolistic market structure (Papi and Revoltella, 2000). It is widely believed that allowing foreign bank entry as part of a liberalization process will enhance the efficiency of the banking system (Litan, Masson and Pomerleano, 2001). Third, foreign bank presence may also lead to improvements in bank regulation and supervision, since these banks may demand improved systems of regulation and supervision from the regulatory authorities in the recipient countries. This may contribute to improving the quality of banking operations of domestic banks (Hermes and Lensink, 2004). All these spillover effects may contribute to more efficient domestic banking practices, which, in turn, may enhance economic growth in transition countries (Koivu, 2002).

**Coverage of the book and methodological approach**

This book is divided in two parts. Part I of this book focuses on Central and Eastern Europe and examines the presence, financial intermediation and entry strategies of foreign banks\(^1\). Part II of this book focuses on tests for the relevance of foreign ownership on bank performance. There are several reasons why studies on foreign bank entry, intermediation in Central and Eastern Europe and foreign bank performance in general are justified. First, (central) banks and policy makers

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\(^1\) Throughout this book, the Central and Eastern European countries include Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.
in developing countries may benefit from studies into the nature and performance of foreign banks in transition economies. In the meantime, an EBRD/World Bank Business Environment and Enterprise performance survey found that lack of access to finance is frequently cited by enterprises throughout the transition region as one of the main obstacles to starting, operating or expanding a business (EBRD, 2005). Given the dominant presence of foreign banks, the question is whether the very fact that these banks are foreign owned correlates with the survey findings.

Also, contradictory evidence on foreign bank performance, measured by financial indicators as profitability and efficiency, gives rise to the need for further examination of the circumstances under which foreign banks are able to show desirable performance. Otherwise, policy makers have to stick with the conclusion of Berger et al. (2005) that “a (...) policy-related observation can be made about the appeal to developing countries of encouraging entry by large multinational banks. Having foreign banking giants set up shop in a developing economy no doubt has a number of significant benefits. For example, they are probably more likely to be stable and financially sound. They might also be less likely to engage in the sort of corrupt related-lending practices documented by LaPorta et al. (2003). Without denying the importance of these factors, our analysis points to a potential trade-off. If large foreign banks substantially crowd out smaller domestic ones, the supply of loans to informationally opaque small businesses could be negatively affected.”

Next, many of the countries in the CEE region have entered the European Union or will, within the coming years. EU membership facilitates banks to establish branches in any EU country. This could support spreading the activities of EU licensed banks or changing the format of subsidiaries in branches. As branch structures are regulated and supervised by the foreign authorities in the country where the foreign owner is located, CEE banking supervisors have signalled concern over the potential loss of supervision over their foreign owned local banks, despite the existence of Memoranda of Understanding. Studies on foreign banking could further support the insight into

2 According to the survey, enterprises in the transition countries finance 75 per cent of new investments with internal funds, and loans from family and friends, including remittances, compared with 65 per cent in mature market economies.

3 A 2002 European Central Bank (ECB) report notes that in many of the foreign-owned banks, trading and other key activities were shifted to the headquarters, so that the subsidiaries in CEE lost some of their important functions.

4 Illustrative of this trend are recent branch openings of Dutch Fortis Bank and Bank of Tokyo Mitsubishi UFJ in the Czech Republic and the transformation of Crédit Lyonnais former Czech subsidiary Calyon into a branch.

5 In the 2001 Report on Financial Crisis Management the Economic and Financial Committee of the ECB concluded that "Regarding the institutional framework on crisis management, the EFC is of the opinion that closer co-operation among the competent authorities is required in the context of increasing financial integration (EFC, 2001). The banking supervisory authorities and the central banks of the new Member States of the European Union (EU) have agreed to adhere to the Memorandum of Understanding on high-level principles of co-operation in crisis management situations, in force since 1 March 2003. The MoU, which is not a public document, consists of a set of principles and procedures for cross-border co-operation between
the dynamics and characteristics.

Fourth, the role of foreign capital in CIS banking systems is expected to increase. In 2001 the limit in Russia of foreign ownership in the banking industry was raised from 12% to 25%. In Kazakhstan and Ukraine, the role of foreign banks has been gradually growing since 1999. About half of Kazakhstan’s banks have some foreign capital in them and total assets of foreign banks in Ukraine currently make about 16% of total Ukrainian banking assets (Golodniuk, 2005). The experience of the transition countries in CEE may be of some help in formulating proper policies.

A special feature of this book is that it makes use of different methodological approaches: Chapter 1 consists of an analysis based on a survey among central banks in the region. The analysis is based on macro data, and data on individual banks from BankScope. Chapter 2 performs a comparative analysis based on micro data. In chapter 3 conclusions are based on structured interviews with bankers and supervisors and in Part II empirical results are based on various econometric techniques like the generalized method of moments (GMM) and ordinary least squares (OLS) (Chapter 4) and stochastic frontier analysis (SFA) (Chapter 5).

Chapter 1 attempts to answer the question: Does foreign bank entry and financial intermediation show similarly trends in Central and Eastern Europe? The chapter examines the growth in the number of foreign banks and their share in total banking assets in CEE. The chapter then looks at growth in financial intermediation in the region. The chapter examines the trend in foreign bank growth versus growth in financial intermediation. Finally, the chapter specifically focuses on the differences between credit extension by foreign owned banks and locally owned banks. The chapter is based on both macro-data and micro data. Due to scarce data for the early transition period, the University of Groningen and the Dutch central bank (DNB) initiated a survey among central banks in Central and Eastern Europe. To present a comprehensive analysis of foreign bank entry the data was supplemented with more recent data from the European Bank for Reconstruction and Development (EBRD). The origin of bank ownership in the region was tracked with Bureau van Dijks’ BankScope database.

Chapter 2 uses bank balance sheets to answer the question: have the nature and size of foreign bank intermediation in Central and Eastern Europe changed over time? The chapter analyzes the size and composition of (foreign) banks’ balance sheets in CEE. The results are compared to two benchmark regions. The first consists of the old EU15 countries as the CEE countries have recently joined the EU (or will soon). The second consists of a set of transition countries in South Eastern Europe banking supervisors and central banks in crisis situations. These principles and procedures deal specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level. The MoU also provides for the setting-up of a logistical infrastructure to support the enhanced cross-border co-operation between authorities. (ECB, 2004).
(SEE) and the Commonwealth of Independent States (CIS), as these countries have similar features as the CEE countries but do not have the prospect of joining the EU. The chapter first compares trends in foreign bank size in the EU15 and in transition countries. Assuming that foreign banks over time learn to deal with information asymmetry and/or other comparable disadvantages vis-à-vis domestic banks, the chapter hypothesizes increasing customer loans over time and presents the dynamics in the composition of the asset side of foreign banks. Third, it shows how foreign banks have organized the liability side. We show how the maturity of customer loans compares to that in banks in the EU15 and other transition countries. The chapter is based on data from Bureau van Dijks’ BankScope database.

Chapter 3 attempts to reveal potential structural features in foreign bank entry strategies and specifically attempts to answer the question: did banks follow their customers in Central and Eastern Europe? First, it analyzes why banks have entered the region. The chapter then focuses on the choice between greenfield and acquisition and reveals the main determinants influencing this choice. Specifically, the chapter intends to reveal the interdependence of the reasons for foreign banks to start operations in another country, the mode of entry i.e. by acquiring an existing bank or by establishing a new bank, and, in case of establishing a new bank, the choice for i.e. a branch or a subsidiary. For this study a joint interview project was set up in collaboration with the Dutch central bank. For this project, representatives of the most important foreign banks in the region were interviewed. To control for the effects of customer focus, the sample was supplemented with interviews with representatives of global banks present in Central and Eastern Europe. To validate the data additional interviews were conducted with representatives of the local foreign owned banks and local financial supervisory authorities.

Part II shifts the focus from foreign bank entry and intermediation to the financial performance of foreign banks and aims to extend the scarce literature on the relationship between foreign ownership and bank performance. Chapter 4 examines foreign bank performance in Central and Eastern Europe. Performance indicators are profit, overhead costs and net interest revenues. A special feature of the research in Part II is that we use a handmade continuous foreign ownership variable. The implication is that we can conclude on the effect a rise in foreign ownership has on performance. This approach slightly differs from using a dummy variable. The dummy variable approach explicitly identifies banks with banks with foreign majority control, i.e. foreign banks, versus banks with minority foreign majority control, i.e. domestic banks. In chapter 4, ownership of a sample of 211 banks in 22 countries in 2001 is analysed in order to construct a continuous foreign ownership dummy. In line with most other studies in this strand we start with ordinary least squares (OLS) regressions to investigate how foreign ownership is related to bank profitability, costs and interest revenues. Several robustness checks are performed controlling for (i) economic development of the transition country, (ii) concentration of the banking sector, (iii) the presence of the relative number of foreign banks, and (iv) the presence
of relative foreign banks’ assets.

Chapter 5 extends the analysis of chapter 4 in several ways. A first extension consists of the use of data of banks worldwide. Second, instead of a cross section we use a panel including data from the period 1998-2001. Similar to chapter 4, for each bank is the exact level of foreign ownership determined in order to construct a continuous foreign ownership variable. A third extension is that in estimating the impact of foreign ownership on bank performance, chapter 5 uses the generalized method of moments (GMM) technique in addition to the OLS approach. In the model specifications we again control for the influence of economic development.

In Chapter 6 we shift from foreign bank profitability research to foreign bank efficiency research. Literature on the relationship between foreign ownership and foreign banks is scarce and most foreign bank efficiency literature focuses on transition economies. A first contribution is that, using a stochastic frontier approach, we estimate cost efficiency correlates of 1,636 banks in 97 countries worldwide. In addition we test for a subset of banks in 43 lower income countries. The most innovative feature of this study is that we investigate the role of the institutional context. Specifically, we aim to answer the following research questions: i) Does bank efficiency depend on foreign ownership? ii) Does foreign bank efficiency benefit from improvements in the institutional framework in the host country? iii) Does foreign bank efficiency depend on the institutional framework in the home country? and iv) Does foreign bank efficiency depend on the distance between /similarity of the institutional framework in the host country and the institutional framework in the home country?

Chapter 7 summarizes the main conclusions of this study.