Foreign bank entry and performance with a focus on Central and Eastern Europe
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Chapter 7
Summary and conclusion

7.1 Introduction
The aim of this thesis is to deepen our understanding of foreign bank behaviour and performance. The analysis consists of six chapters, organized in two parts. In Part I of this book we examine the entry and the nature of foreign bank activities in Central and Eastern Europe. In Part II we empirically study the impact of foreign ownership on bank performance.

The first research question is i) What is the role of foreign banks in the financial sector in Central and Eastern Europe? Chapter 1 consists of an analysis based on macro data from a national bank survey. Chapter 2 performs a comparative analysis based on micro data. The second research question is: What are the reasons for foreign banking in Central and Eastern Europe and how do these reasons relate to the mode of entry and the organizational form of the foreign owned bank? The available evidence is scarce and based on a few country studies. In chapter 3 conclusions are based on a multiple case study. Finally, this book focuses studies the question: Does foreign ownership affect bank performance? Chapters 4 and 5 present results on the relationship between foreign ownership and profitability based on OLS and GMM estimations. Chapter 6 presents the evidence on the relationship between foreign ownership and bank efficiency using the stochastic frontier technique. The remainder of this chapter rounds up the main findings of the chapters and provides for some suggestions for further research.

The aim of the rest of this chapter is to summarize the main findings of the analyses and propose some directions for future research.

7.2 Summary of the main findings
In chapter 1 we start our study on foreign banking by focusing on the role of foreign banks in the financial development of Central and Eastern Europe and specifically on their role as providers of credit to the private sector. The chapter starts out amending the global advantage theory of Berger (2001) that assumes that foreign banks have a comparative advantage over domestic banks due to their ability to export at low cost best-practice banking. Focussing on Central and Eastern Europe, this theory may be not hold due to a lack of track record of company performance, the problems good firms in this region have to signal that they are a ‘good firm’ and the quality of the judiciary. Next, the chapter measures foreign bank presence in Central and Eastern Europe in two ways. Data show that in 1995 one in four banks was foreign owned and by 2004 more than 60 per cent of the banks were foreign owned. However, measuring the importance of foreign banks by their relative number underestimates
their relevance in the financial system: by 2004, foreign bank’ assets had accounted for more than 80% of total banking assets in Central and Eastern Europe, while in 1995 foreign banks’ assets accounted for less than 5% of total banking assets. It appears that foreign banks in European transition economies are attracted mainly from Austria, Belgium, Germany and Italy countries. To a lesser extent, foreign banks from the US, France and the Netherlands play a role. Intraregional financial investment is virtually non-existent. Data do not reveal a one-on-one relationship between growth in foreign bank presence and growth in credit to the private sector. In Central and Eastern Europe, credit to the private sector remained unchanged between 1995 and 2001 on a 23 percent of GDP level and only started to take off from 2002 to 34 percent of GDP in 2004. Foreign banks have changed their lending behaviour over time. From 1993-1998 foreign banks extended more credit to the public sector than to the private sector. Only from 1998, credit to the private sector by foreign banks exceeded their credit to the public sector. However, both findings are not unique for foreign banks as they also apply to credit supply by domestic banks. Only from 2000, domestic banks and foreign banks the objectives of foreign and domestic banks differ, as the latter primarily focus on extending credit to the private sector. The chapter finds no evidence for the global advantage theory as up to 1998 foreign banks underserviced the private sector in Central and Eastern Europe. Even in 2000, foreign banks underserviced the private sector in Croatia, the Czech Republic, Lithuania and Poland. However, foreign banks seem to be more profitable in terms of ROE and ROA although the data do not suggest that foreign banks incurred less overhead costs or earned higher net interest revenues.

Chapter 2 highlights the growth in foreign bank size in Central and Eastern Europe if compared to foreign bank size in the former EU15 countries and in less developed European transition economies. Aggregated loan data from bank balance sheets as available in the BankScope database confirm the findings in chapter 1 that intermediation in CEE remained relatively stable during the late 1990s and takes off only from 2002. Further examination of the balance sheets data finds evidence that foreign banks are more risk avers than domestic banks as problem loans and loan loss reserves of foreign banks in all three regions exceed those of domestic banks. The data also suggest that foreign banks in transition economies have more non-earning assets than foreign banks in developed economies. Next, we find evidence that foreign banks in both the EU15 and Central and Eastern Europe have more loan and lease contracts with the corporate sector than domestic banks.

In chapter 3 the results of an interview project show that foreign banks primarily entered Central and Eastern Europe both as a result of high expected profit and because of reasons related to reputation and status. Regarding the latter, the majority of banks seem to have been motivated more by following the competition than by the need to follow their existing customers. Chapter 3 observes some dynamics in customer focus. Banks that entered Central and Eastern Europe in an early stage, usually the global banks, did follow non-financial investment. Over the years, customer focus of foreign banks diversified because of i) decreasing margins in the corporate sector
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due to increased competition and ii) privatisations of former state owned banks. The shift in customer focus was also accompanied by a shift in the mode of entry. While the early enterers preferred to establish greenfield investments, foreign banks that entered at the end of the nineties preferred to take over existing banks as the increased competition made the greenfield alternative less attractive.

In Part II, the book shifts the attention to empirical analyses on the effect of foreign ownership on bank performance. Following the method of Demirgüç-Kunt and Huizinga (1998), we test whether foreign ownership has an effect on bank profitability. We consider two variables of foreign ownership: i) a continuous variable and ii) a dummy variable. The results in chapter 4 show that in European transition economies foreign ownership is negatively related to banks’ net interest revenues, overhead costs and profitability. Several other specifications confirm the robustness of the negative relationship between foreign ownership and bank profitability. First of all, estimation results show that economic development does not influence the negative relationship between foreign ownership and bank profitability. Neither the competitive conditions in the banking sector, nor the presence of foreign banks have any impact on this relationship.

In chapter 5, we extend the analysis of chapter 4 with a BankScope 1998-2001 panel of banks worldwide. The data show that worldwide one third of the banks are foreign owned. Differences in foreign bank presence arise when we group countries according to economic development. We find evidence that banks prefer to enter new markets in upper middle income countries, for example the CEE region, and that their market share, measured by relative assets, is highest. This would suggest that the competition in mature banking markets in high income countries and the risk of doing business in low income countries both deter foreign banks from being able to similar market shares as they have in the upper middle income countries. We use OLS and GMM estimations to examine the effect of foreign ownership on banks’ net interest revenues and profitability. The results confirm the findings of chapter 4 regarding an inverse relationship between foreign ownership and bank performance.

Chapter 6 focuses on the relationship between foreign ownership and bank efficiency. Up to now, the scarce foreign bank efficiency literature has found that foreign banks in developing countries are more efficient than domestic banks, while foreign banks in developed countries are less efficient than domestic banks. Besides the evidence on the relevance of host country characteristics for foreign bank efficiency, Berger et al. (2000) and Havrylchyk (2006) argue that home country characteristics matter for foreign bank efficiency. Based on a 1998-2001 panel of banks in 93 countries worldwide we find using the stochastic frontier approach, that foreign ownership is negatively related to cost efficiency. With additional estimation results we show that the improvement in the institutional context of the host country positively affects foreign banks’ cost efficiency. Also we show that an increase in the quality of the institutional context in the home country raises foreign bank matters. Finally, we provide evidence that similar quality of the institutional environment between the host and the home country positively affects foreign bank efficiency.
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7.3 Policy implications, suggestions for further research and conclusion

Since the 1990s, Central and Eastern European banks have increasingly become foreign owned. The evidence on foreign bank behaviour in Central and Eastern Europe shows that several years past before their relative credit supply to the private sector met their relative presence. Several factors seem to underlie this reserve. First, the entry strategy of the first foreign banks entering Central and Eastern Europe in the early 1990s entailed a focus on existing clients from Western Europe and on the bigger companies in the host country. Though this strategy might have confirmed some in their criticism that foreign banks underservice the lower segments in the credit market, this strategy was also determined by some specific features of banking in transition economies and developing countries. Assuming that banks prefer safe banking to risky banking, banks i) prefer to be able to distinguish a ‘good borrower’ from a ‘bad borrower’, i.e. the adverse selection problem and ii) need to be able to seize the collateral in cause of default or bankruptcy. Foreign banks in Central and Eastern Europe seem to have been suffering from the inability to overcome the adverse selection in all credit segments, to price collateral and to seize it in case of default.

We notice that in Central and Eastern Europe credit to the private sector in terms of BNP remained stunted until the early 2000s and argue that the diversification of banks’ loan portfolio towards the SME and retail sector in the late 1990s seems to have been induced primarily by the competitive conditions in corporate banking rather than by a voluntary strategy to resolve credit constraints in the lower segments of the market.

We conclude that if governments and financial authorities in transition economies and developing economies decide to allow foreign banks to enter their national financial sector with a physical presence, policy should be directed at mitigating the obstacles associated with (foreign) banking in such economies. First we argue that, as the adverse selection problem in Central and Eastern Europe was largely due to the lack of historical data of borrowers, governments should consider initiating an institution that pools financial data of companies nationwide and provides access for banks to these data. In addition, an official rating office would enhance the ability of a ‘good borrower’ to signal that she is a ‘good borrower’ thereby increasing her chances of obtaining a bank loan.

A second challenge of foreign banking in transition economies, besides overcoming the adverse selection, has been to deal with the time-consuming and unpredictable process of going to court to seize collateral in case of loan default or bankruptcy. In this respect, policy should be directed at providing for laws that protect both debtors and creditors according to the rules of reasonableness and fairness. In many countries in Central and Eastern Europe the incentive to such policy was the prospect of EU accession. At the same time policy should be initiated to i) enhance the enforcement of the law, e.g. by monitoring the relationship between bankruptcy administrators and judges and retrain judges with respect to new law, and to ii) eliminate corruption within the judiciary in general and of judges in particular, e.g. by raising salaries.
The result from our central bank survey that in Central and Eastern Europe foreign banks have been more profitable than domestic banks in the period 1995-2000 confirms results in Bonin, Hasan and Wachtel (2005), Majnoni, Shakar and Várhegi (2003), Claessens et al. (2001), Kraft and Tirtiroglu (1998) and Sabi (1996).

An interesting venue for further research would be to empirically assess the correlates of this superior foreign bank performance, as we show that, in this timeframe, net-interest revenues of domestic banks seem to have been higher than that of foreign banks and that overhead costs of foreign and domestic banks have been of comparable size. One could consider including the quality of loan portfolios in line with Berger and DeYoung (1997), who focus on the relationship between problem loans and cost efficiency in commercial banks.

Though foreign banks might have been more profitable in the early transition period in Central and Eastern Europe, our empirical analysis of foreign bank performance shows that, in 2001, the superior profitability of foreign banks has disappeared. More important is that, in an additional study with data on foreign banks worldwide, we find that in general foreign ownership is negatively related to bank profitability, irrespective of the economic development of the host country in which the foreign bank is active. This result contrasts with the findings of a study into the determinants of commercial bank profit of Demirgüç-Kunt and Huizinga (2000) with data from 1998-1995, that foreign banks are more profitable than domestic banks in developing countries but less profitable and that the former are less profitable in developed countries. Additional research could explain whether the sample period influences the way in which the economic development of the host country affects the relationship between ownership and profitability. To complement the literature on the nexus between ownership and bank performance, additional research could be directed at the correlation between foreign ownership and concentrated ownership and the correlation between domestic ownership and dispersed ownership.

Complementary evidence on the relevance of the institutional environment is shown by our research into the determinants of banks’ cost efficiency. We find that an increase in the quality of institutions enhances foreign bank efficiency. We argue that governmental policy aimed at improving the institutional context would benefit bank efficiency especially in those countries where the banking sector is dominated by foreign banks, e.g. in Central and Eastern Europe, Sub-Saharan Africa, Latin America and the Caribbean. Examples of such policy would consist of policy directed at eliminating people’s receptiveness toward corruption, and raising the effectiveness and predictability of the judiciary. Other examples would be to aim for increasing the quality of banking supervision, eliminating bureaucracy at the governmental level and provide for media independence.

Regarding the relationship between foreign ownership and bank efficiency we find with 1998-2001 data of banks worldwide that are negatively related in both developed economies and developing countries. This result contrasts with the findings of studies as Grigorian and Manole (2002), Jemric and Vujcic (2002), Nikiel and
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Opiela (2002), Yildirim and Philippatos (2003), Hasan and Marton (2003), Matousek and Taci (2004), Weill (2003), Bonin, Hasan and Wachtel (2005), Fries and Taci (2005) and Havrylchyk (2006) that find that foreign bank efficiency exceeds domestic bank efficiency in Central and Eastern Europe. We conclude that next to foreign banks’ relative superior profitability vis-à-vis domestic banks, their efficiency advantage has evaporated as well by the end of the 1990s. Future research in this field could be directed at focusing on the relationship between foreign bank efficiency and the mode of entry. Does the efficiency of a bank being acquired by a foreign bank differ from the efficiency of a foreign bank established as a greenfield? Studies focusing on the profitability of foreign banks could also include the mode of entry as an additional explaining variable. Results could further inform policy makers on the externalities of foreign bank entry regulation.

In sum, we conclude that in the 1990s, non-financial FDI as well as financial FDI and optimistic profit expectations have moved foreign banks, predominantly from Western European countries, to invest in one or more entities in Central and Eastern Europe. Second, we conclude that while the foreign banks that entered in the early transition period preferred to set up greenfields in the shape of a representative office, a branch or a joint-venture with other banks and that the ‘late comers’ would take the opportunity to bid for state owned (saving) banks that governments appointed for privatisation. Third, we conclude that the growing presence of foreign banks, based rather on their relative assets than on their relative numbers, increased the competition in the banking sector. Fourth, we argue that the increased competition decreased the margins in corporate banking and forced banks to diversify their loan portfolio. Fifth, we conclude that in an early transition period foreign banks are more profitable and efficient than domestic banks, but that eventually domestic banks are able to show better performance. Finally, we suggest that the inverse relationship between foreign ownership and bank performance gives cause for a new strand of literature that, instead of focusing on the effects of cross-border mergers, investigates profitability and efficiency effects of foreign banks after having been acquired by national domestic owned competitors. Ex ante we would expect positive effects.