Foreign Ownership of Banks

David Tripe

Centre for Financial Services and Markets

Massey University

Introduction

- Long history of foreign involvement in New Zealand banking sector – from the 19th century
  - Union Bank
  - Oriental Bank – transferred its business to Bank of New South Wales
  - Bank of Australasia
  - Bank of Otago – business acquired by National Bank of New Zealand

Changes in the 20th century

- Realignment of existing banks
- Entry of new banks and conversion of other institutions to banking status following deregulation
- By end of 1996, New Zealand banking system 99% foreign-owned
- Transformation of banking, not always in ways customers liked

Where are we now?

- Four New Zealand-owned registered banks, with combined market share of 6%
- Other countries now with significantly foreign-owned banking systems – particularly in Central and Eastern Europe and in Latin America
- Wider range of countries provides a basis for proper research not confounded by individual, idiosyncratic factors

The complaints against foreign-owned banks

- Profits will leave the country
- Banks will act in home country (rather than host country) interests: could be reflected in reduced availability of lending (particularly to small business), service standards, lack of understanding of host country practices
- Host country may be robbed of resources

Views from academic researchers on Foreign Banks

- Foreign banks may improve efficiency and competitiveness of the banking sector in host country (Claessens, et al., 2001; Bonin, Hasan & Wachtel, 2005; Berger, Hasan & Zhou, 2009)
- Foreign banks may increase availability of funds at favourable rates (Claessens et al., 2001; Dopico & Wilcox, 2002)
- Alternative view is that they destabilise the host country banking system (Hellmann, 2002)

Efficiency and competitiveness

- Topical in New Zealand context to discuss profitability of foreign banks. Press has described foreign bank profits as ‘mind-boggling’ (van den Bergh, 2011) and ‘excessive’ (van den Bergh, 1999)
- Research comparing profitability of foreign banks with domestic banks suggests that foreign banks relatively more profitable (Chen & Liao, 2011; Havrylchyk & Jurzyk, 2011; Berger, Hasan & Zhou, 2009; Bonin, Hasan & Wachtel, 2005; Kosmidou, Pasiouras & Floropoulos, 2004)

….but other things being equal

- Foreign banks should be at a disadvantage in entering new markets because of the liability of foreignness, which means that they lack existing networks of customer relationships
- Foreign purchases of existing banks may not cause the bank to be identified as foreign

Efficiency and competitiveness

Reasons suggested for superior relative profitability of foreign banks include:

- Better revenue generating ability and risk management (Berger, Hasan & Zhou, 2009; Bonin, Hasan & Wachtel, 2005)
- Differences between the level of development, regulation and culture in home and host countries (Claessens & van Horen, 2012)

Foreign banks outperform because

- Market share growth arising from lower prices reflecting cost efficiencies and better risk management (Havrylchyk & Jurzyk, 2011)
- Management of assets and liabilities (Kosmidou, Pasiouras & Floropoulos, 2004)
- Experience of operating in competitive markets in foreign bank home countries (Chen & Liao, 2011)

Efficiency and competitiveness

- Underlying causes of relatively higher profitability reflect competitiveness and efficiencies of foreign banks compared to domestic banks
- But is this a benefit enjoyed by new entrants, rather than being specific to foreign banks?

Which is the important dividing line?

Long-standing domestically-owned banks	Domestically-owned new entrant banks
Long-standing banks acquired by foreign owners	Greenfield banks established by foreign owners

Foreign banks improve the functioning of host country banks through…

- introducing new products and new, more efficient, technologies (Guillen & Tschoegl, 2000; Berger & Udell, 2006)
  - Information systems and risk assessment first areas to be improved, followed by the introduction of new products
- better management expertise and organisational structures (Guillen & Tschoegl, 2000; Manlagñit, 2011; Zhu, 2011)

Foreign banks improve the functioning of host country banks through…

- lower prices (Guillen & Tschoegl, 2000; Martinez, Peria & Mody, 2004), although Degryse et al (2011) suggest that lending rates reflect portfolio composition and that foreign banks' lending rates are no less than rates charged by domestic banks
- improved customer service (Hasan & Morton, 2003)

Efficiency and competitiveness

The increased competition causes domestic banks to:

- Renew/reorganise/modernise to meet the competition
- consolidate (Guillen and Tschoegl, 2000)

Credit expansion

- Higher credit ratings of foreign banks and access to foreign savings increase funding capacity and ability to lend (Buch & Golder, 2001; Clarke et al, 2005)
- But does host country credit rating matter? What if this deteriorates?

Credit expansion

Ambiguity as to whether foreign banks generate credit growth (Rraci, 2010; Popov & Udell, 2012; Zungacova et al, 2012)

- Foreign bank entry into Argentinian provinces coincided with lending growth (Clarke, Crivelli & Cull, 2005)
- Fries & Taci (2002) found that foreign ownership did not correlate to real growth in lending but a greater presence by foreign banks had a positive spillover into real lending growth. Credit growth as a result of foreign bank entry may be indirect rather than direct (Giannetti & Ongena, 2012)

Credit expansion

Entry of foreign banks leads to reallocation of lending

- Foreign banks are thought to *cherry-pick* transparent credits and domestic banks forced to lend more to opaque borrowers (Dell'Ariccia & Marquez, 2004; Clarke, Cull, Peria & Sánchez, 2005; Zhu, 2011; Degryse et al, 2011), leading to reallocation of credit (Lin, 2011)
- The reallocation of credit increases riskiness of domestic banks' portfolios and introduces instability to banking system (Degryse, et al, 2011)

Credit expansion

Operation of an internal capital market by foreign banks may translate into a more stable credit supply (Houston et al., 1997; Houston and James, 1998; de Haas and Lelyveld, 2006)

- Evidence from Latin America (Dages et al, 2000; Crystal et al, 2002) indicated that established foreign banks achieved stronger and less volatile credit growth than domestic banks

Credit expansion

- Rosengren (2000), Goldberg (2001) and Soledad Martinez Peria et al (2002) found that foreign banks did not reduce credit supply during adverse economic circumstances
- Similar findings by van Lelyveld (2004) and Kraft (2002) for CEE countries

Credit expansion

- Dages et al (2000) and Crystal et al (2002) suggest that bank health, not ownership, critical as domestic and foreign-owned banks with low problem loan ratios behaved in similar ways

Banking system stability

Foreign banks perceived to bring greater stability to markets they expand into (Dages et al, 2000)

- Parent bank may provide back up during crisis periods
- Foreign banks have access to more diversified, international pool of liquidity - operation of internal capital market and centralised treasury enable liquidity and capital allocation across countries, to dampen effects of host country bank capital shock (Clarke et al, 2003)

Banking system stability

But critics point to volatile credit supply posing risks for banking system stability (de Haas and Lelyveld, 2006)

- Policies of foreign banks' subsidiaries subject to decisions by foreign bank parent (Clarke et al, 2003; Hryckiewicz & Kowalewski, 2011; *The retreat from everywhere,* 2012; Wu et al, 2011)

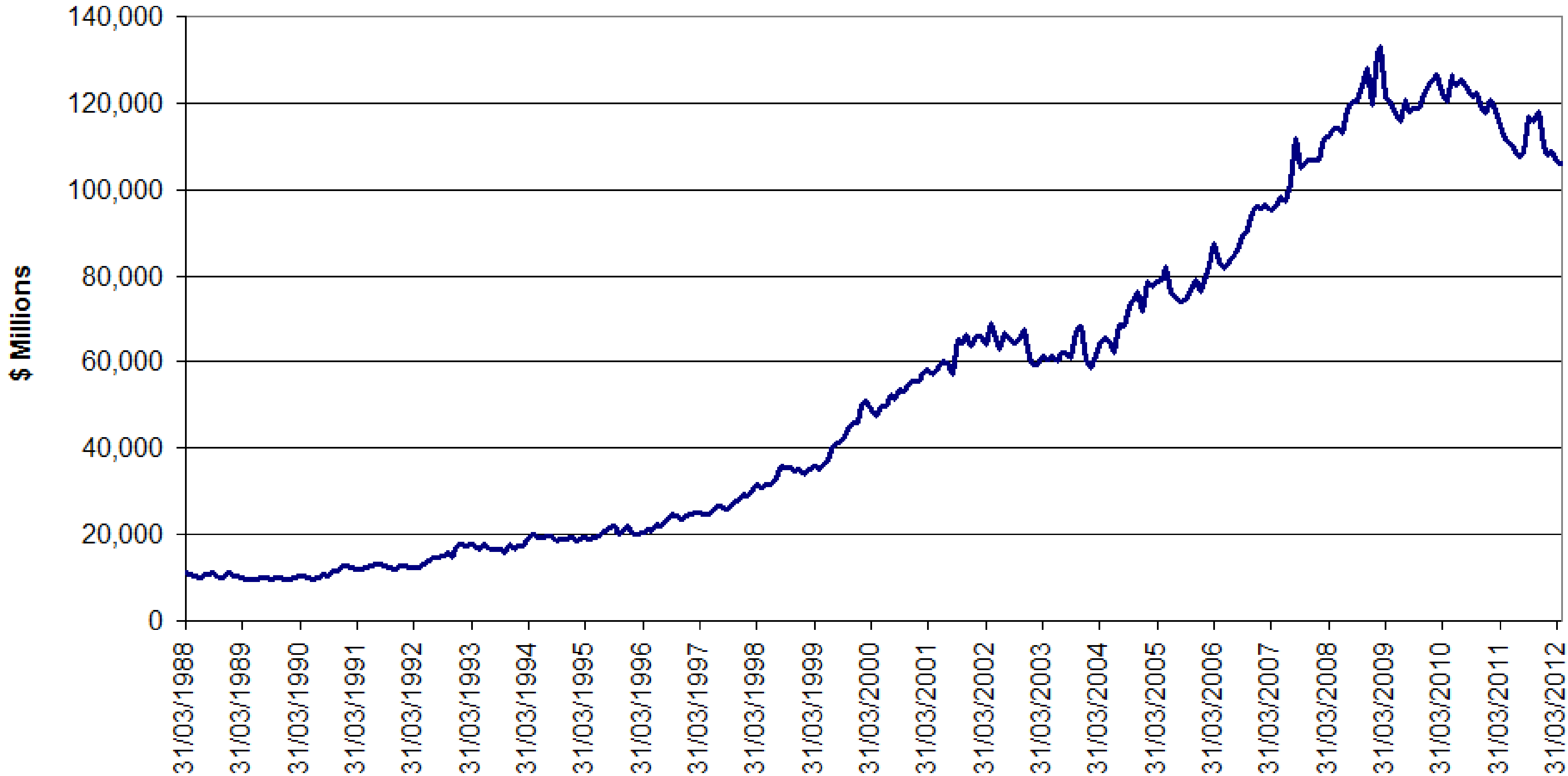
Banking system stability

- Problems in foreign bank's home country may be exported to host country (Molyneux & Seth, 1998; Moshirian, 2001)
- Foreign banks may act pro-cyclically when host country's macro-economic environment deteriorates
- But what happens if the home country suffers a credit rating downgrade?

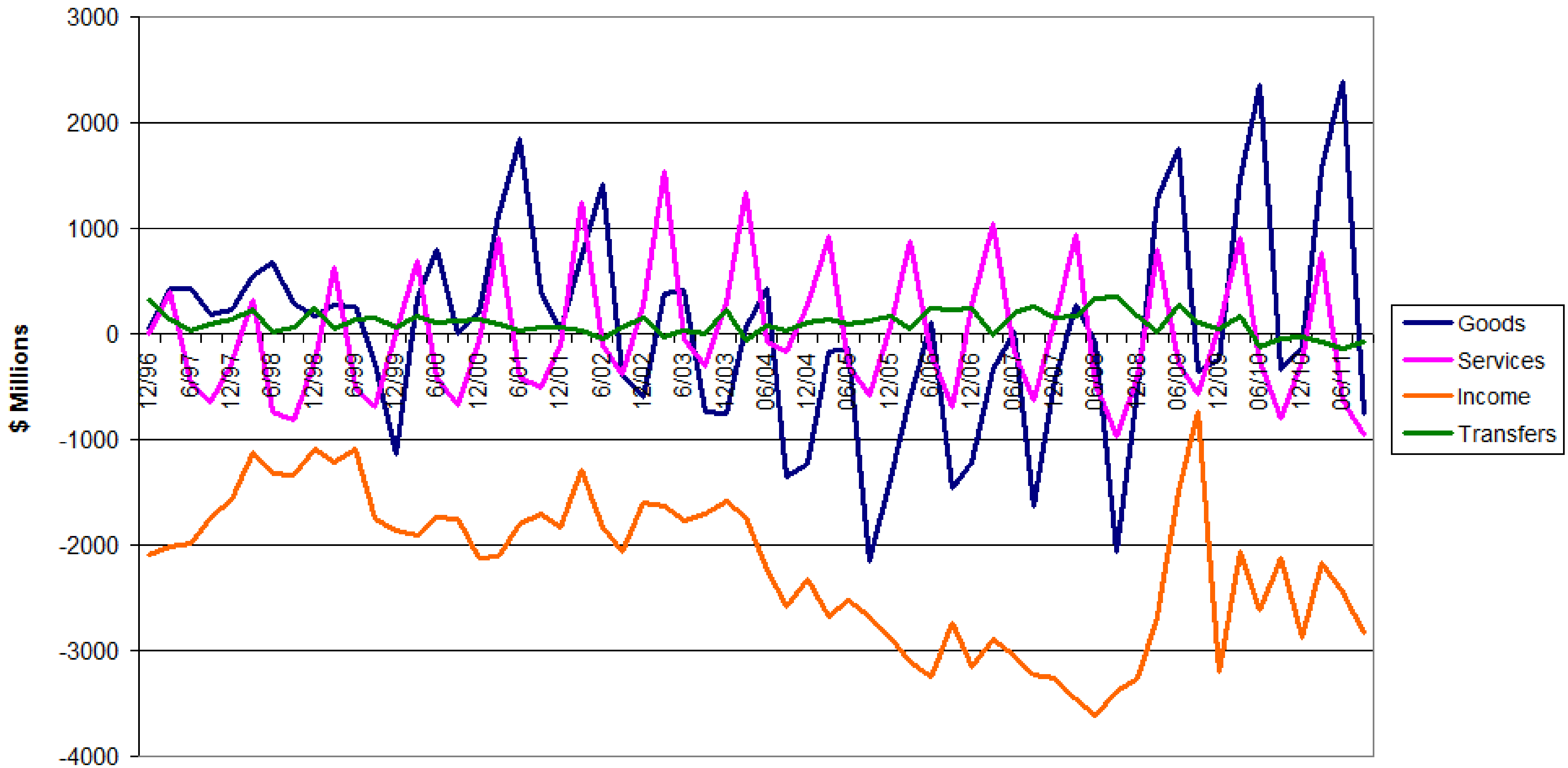
Questions on stability and credit supply

- If foreign banks can ensure the availability of funding, will this allow excessive credit expansion to occur in the host country?
- Will foreign inflows of funds allow the exchange rate to settle at a higher level than otherwise?
- Can the profits of foreign-owned banks lead to a chronic current account deficit?

TOTAL NON-RESIDENT FUNDING OF THE NEW ZEALAND BANKING SYSTEM



NEW ZEALAND BALANCE OF PAYMENTS CURRENT ACCOUNT - INDIVIDUAL COMPONENTS



Question on financial stability

- Can foreign owned banks frustrate or undermine the objectives of financial system oversight by acting in home country/parent bank interests?
- Is there evidence of this actually happening?
- Relates to questions around management of cross-border insolvency

Implications for research

- Greater research required on the effect of foreign bank ownership in good times, but more particularly during crises
- Good opportunities for this in aftermath of GFC
- Are host country banks being squeezed as their parents reposition themselves for Basel III?

Foreign bank ownership and sovereign debt

- Banks would usually be expected to hold some host country sovereign debt, to allow them to engage in local money market operations
- What happens in practice?
- What makes some situations more risky than others?

Foreign bank ownership

- Do consumers understand which banks may be foreign owned, and perceive that there may be higher (or lower) risks accordingly
- Tripe et al (2009) found that New Zealand consumers had difficulty in correctly identifying which banks were foreign-owned

Some suggested analysis

How do foreign-owned banks perform?

DV = f(Parent bank factors, home country factors, host country factors,(host country), bank specific factors, time) + error term

Dependent variables (DV) include lending growth and profitability (measured by return on average assets). Bank specific effects include capital and profitability. Country specific effects include interest rates, loan to deposit ratios and country (sovereign) credit ratings.

More suggested analysis

The impact of foreign ownership on countries' debt levels

DV = f(banking system factors, bank ownership factors, host country macroeconomic factors) + error term

Dependent variables (DV) are CDS and sovereign bond spreads. The key banking system factor is size of the banking system relative to economy as a whole. Measure of impact will be on significance of coefficient for bank ownership factors

Summary and conclusion

- We’re very good at complaining about foreign-owned banks, but there is a dearth of research to substantiate (or refute) those complaints
- Scope for such research has been enhanced by the wider range of countries that now have significantly foreign-owned banking systems
- Such research as there is often points to contradictory conclusions!