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Economic determinates, financial crisis and entry modes of foreign banks into emerging markets

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ABSTRACT

In the last two decades, foreign banks have significantly expanded their presence in several emerging markets. The expansion of foreign banks has continued despite the global financial crisis. In the study we establish the role of economic factors and their relevance in driving a bank's expansion decision into emerging markets. The results confirm that the economic factors influencing the location choice of banks vary with respect to the economic condition of the home and host countries. Moreover, the results show that these factors may influence a foreign bank's choice of organizational structure in emerging markets.

1. Introduction

In the last two decades, many countries, particularly those with emerging economies, have witnessed an increase in foreign banking activity in their banking sectors. This increase in activity has been largely led by the privatisation of state-owned banks and the rescue of distressed domestic financial institutions by multinational banks. As a result, Claessens et al. (2008) reported that the percentage of domestic banks among total banks in the developing world declined from 77% in 1995 to 62% in 2006, while the share of foreign banks increased from 23% in 1995 to 38% in 2006. Today, more than 50% of banks have foreign owners in approximately 45% of developing countries. Strikingly, this figure exceeds 80% in several emerging markets, especially in Latin American and Central and Eastern European (CEE) countries.

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Multinational banks enter foreign markets primarily to increase their profitability within an acceptable risk profile. Indeed, the characteristics of a host country that are related to profitability and risks have been found to be important drivers of a bank's decision to penetrate emerging markets. Focarelli and Pozzolo (2005), for example, found that banks prefer to maintain subsidiaries in countries where expected profits are larger because of higher expected economic growth and the prospect of benefiting from the inefficiencies of local banks.

The impact of a foreign bank's entry on a host country's banking system is that it undermines the local conditions that attracted it in the first place. In an inter-country study, Claessens et al. (2001) showed that foreign banks reduced profitability and diminished overhead for domestic banks and that this led to improved efficiency. This evidence of increased bank efficiency and intensified competition after a foreign bank's entry into emerging markets is also supported by country-specific studies (Koutsomanoli-Filippaki et al., 2009).

As a result, the presence of foreign banks has typically been considered a positive development in emerging markets. However, there have also been recent studies illustrating the negative effects of a foreign bank's entry into host countries. Giannetti and Ongena (2009) suggested that domestic banks might cut back their own lending in response to foreign bank entry. Likewise, Gormley (2010) found that in India, after foreign bank entry, firms were eight percentage points less likely to receive a loan because of a systematic drop in domestic bank loans.

Furthermore, a number of studies have also pointed out different effects of foreign banks on the stability of emerging banking sectors, especially during a time of global financial crisis. For example, Schmidt (2009) found that foreign banks that enter new markets through greenfield operations are more exposed to higher competition in a host country and therefore to lower profits. As a result, these banks take on more debt than other institutions in order to increase their profitability. At the same time, they have a lower incentive to undertake costly monitoring. Consequently, in a time of economic downturn, the credit quality of loan portfolios in these banks deteriorates faster than in other credit institutions.

The current global financial crisis has additionally demonstrated that even the largest foreign banks are not immune to sharp reversals in the economy and the attendant fallout from a widespread liquidity crunch. Moreover, many governments in developed countries have had to provide support to their respective multinational banks to retain confidence in them and their own financial system. The deterioration of financial conditions in a large number of multinational banks and the sharp revision in the pricing of risk have increased the possibility of a reversal in their activities abroad, especially with respect to lending. Indeed, some of these banks have decided to review their foreign operations and close or sell their underperforming franchises. Therefore, the global financial crisis may change the structure of the financial industry in Central Europe as well as in other emerging economies. At present, however, none of the foreign-owned banks has pulled out of Central Europe, with the exception of AIG Bank. Nevertheless, during the global financial crisis, there were 17 systematically important local banks that failed, though this was mostly in Russia and Ukraine. Those banks and other domestic financial institutions weakened by the financial crisis are currently potential targets for foreign banks to acquire in order that these foreign banks enter or increase their share in some of the emerging markets.

In CEE, the transformation of the current banking structure may also be further triggered through the action of the European Commission as part of the review process for state aid granted to many banks during the financial crisis. The Irish-based Allied Irish Bank (AIB), for example, has announced its plans to sell its majority stake in the third largest bank in Poland in order to raise capital and repay the state aid it received during the financial crisis. After the announcement, already more than a dozen, mainly European multinational banks have expressed their interest in buying it. At the same time, the Irish bank has been unable to sell its minority stake in a US bank since 2008. In contrast, one year earlier, AIB entered the Latvian, Estonian and Lithuanian markets by acquiring AmCredit's mortgage finance business from the Baltic–American Enterprise Fund. As such, this situation shows that the financial crisis has created opportunities for foreign banks to enter the Central European and other emerging markets through acquisition. Therefore, questions arise over what causes foreign banks to enter now-emerging markets.

In our study, we try to establish the role of economic factors and their relevance in driving a bank's expansion decision in light of international business cycles. Our framework permits us to examine the relation between the relative importance of the factors within different countries and the entry mode chosen by foreign banks into the Central European region. Our sample includes the entries of foreign banks