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A note on foreign bank ownership and monitoring: An international comparison

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Abstract

This paper empirically analyzes the relation between foreign bank ownership and the three pillars of the New Basel Capital Accord (i.e., capital regulatory oversight, supervisory oversight, and market discipline). Using a new database covering 153 countries, we find that countries with greater market discipline have a lower presence of foreign banks operating in their economy. Furthermore, our evidence indicates that capital regulatory oversight and supervisory oversight are not significantly related to foreign bank ownership.

JEL classification: F01; G21; G34

Keywords: Banking; Basel; Foreign ownership; Market discipline; Monitoring

1. Introduction

A well-functioning financial system is important to promote economic growth and stability, particularly in low and middle-income countries (Levine, 2005; Barth et al., 2006; hereafter BCL). In addition, a growing body of research shows that, in order to provide strong and stable financial markets, better informed management and improved supervisory practices, along with more reliable information, are needed (see Barth et al., 2004; Demirgüç-Kunt et al., 2004; Barth et al., 2007). In particular, recommendations from the industrialized countries that comprise the Basel Committee, labeled the New Basel Financial Accord, or Basel II, provide such guidelines. The Basel II guidelines, which were to be implemented in 2006, are categorized into three pillars: capital regulatory oversight, supervisory oversight, and market discipline. The goal of these risk-based measures is to promote efficient capital allocation by (1) encouraging banks to utilize risk-based capital ratios, (2) increasing the ability of regulatory officials to oversee banks, and (3) improving the quality of information disseminated to the market.

The most complete form of bank regulation is outright ownership. This form of control would be preferred if government-owned banks facilitated the mobilization and allocation of savings toward strategic projects with long-term economic benefits. However, studies show that the concentration of government ownership in a domestic banking system is negatively related to the financial development, performance, and growth of a host economy (BCL; La Porta et al., 2002).

In addition, research has focused on the economic impact of foreign bank ownership. These results are mixed. One view holds that the unfettered entry of banks into a country could result in destabilization of the banking system through the introduction of excessive risk without commensurate returns (see Hellmann et al., 2002, 2000). Alternatively, other research suggests that the presence of foreign banks can improve overall competition and provide greater availability of funds at more favorable rates, ultimately providing a more sound banking system (see Berger and Humphrey, 1997; Claessens et al., 2001; Dopico and Wilcox, 2002). Furthermore, more efficient foreign banks

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provide greater improvements than domestic and government-owned banks for emerging economies (see Berger et al., 2004, 2005).[1]

To date, the literature provides evidence that both foreign bank ownership and the Basel II Accord can improve economic conditions within a country. In general, the original Basel principles and the new Basel II Accord are directed at promoting sound banking and supervision practices and do not, per se, directly address the presence of foreign ownership within a host country. Yet, it is conceivable that the decision of foreign banks to operate within a country is contingent upon a host country's overall competition or policies regarding capital restrictions and regulatory oversight. No study has focused on what influence, if any, the Basel guidelines have on the presence of foreign bank ownership.

This study empirically evaluates the presence of foreign bank ownership within a domestic economy and its association with overall banking soundness, as promoted by the Basel Committee guidelines. If foreign banks self select to operate in an economy, what policy attributes seem to affect their decision? To test this notion, we examine the relation between foreign bank ownership and each of the three pillars of Basel II: capital regulatory oversight, supervisory oversight, and market discipline. We find that the level of market discipline in a country, as measured by the level of monitoring, is negatively related to the presence of foreign ownership. In addition, our findings indicate that capital regulatory oversight and supervisory oversight have no relation to foreign ownership.

2. Data, methodology, and descriptive statistics

We use the country-level dataset from BCL, which represents the most comprehensive, country-level data currently available regarding global banking systems. BCL, in conjunction with the World Bank, gathered responses to 262 questions from central banking authorities in 152 countries.[2] The time period for completion of the survey was 2003 and early 2004. As BCL note, the responses represent the "official" government position. The dataset includes a number of indices, constructed by combining answers to related questions, to measure elements of governance and regulation, such as capital requirements and regulation in a country and the extent to which there are government-imposed limitations to foreign bank entry and ownership. The availability of this data allows for a broader empirical examination of foreign bank ownership than was previously possible.

Our model defines foreign ownership as a function of variables measuring each of the three pillars of Basel II, as well as controls for the political economy and economic prosperity in each country. The model is of the following form:

$$\text{Foreign ownership} = \alpha + \beta_1 \text{Basel II} + \beta_2 \text{POLITICAL} + \beta_3 \text{ECONOMY} + \varepsilon. \tag{1}$$

The exact definition and source of each variable is given in Table 1. Basel II contains measures for the three pillars. The first pillar, capital regulatory oversight, is measured using the capital regulatory index, which considers several degrees of capital that banks are required to possess, as well as the extent to which that capital is verifiable by banking authorities. The second pillar, supervisory oversight, is estimated using two separate components: supervisory power and supervisory independence. Supervisory power values the extent to which banking authorities have the power necessary to take appropriate action. Supervisory independence indicates whether the banking authority is independent from the government.

The third pillar, market discipline, is estimated using a measure of monitoring that is an equally-weighted index of three elements that control for the reliability and existence of external bank monitoring.[3] The first two elements are the percent of the 10 biggest banks rated by international and domestic credit rating agencies, respectively. These controls capture the level of monitoring outside the control of the bank. The third element is the external governance index (EGI) used by BCL, which includes components pertaining to the effectiveness of external audits, the transparency of financial statements, whether banks use International Accounting Standards (IAS) or US. Generally Accepted Accounting Principles (GAAP), and the evaluations by rating agencies and the incentives for future monitoring by creditors.

In keeping with earlier works, we control for country-specific political variables contained in POLITICAL. One control measure is the influence of democracy on foreign ownership. This captures the degree to which a particular country adheres to the democratic process, resulting in greater transparency in government. We expect the level of democracy to bear a positive relation with the degree of foreign ownership, ceteris paribus. In addition to democracy, the adherence to the rule of law, or corruption index, is of major importance to any entity operating in another country. Our measure of corruption provides a long-term indication of the overall level of government

[1] See Goldberg et al., 2000; Crystal et al., 2002; Unite and Sullivan, 2003; Bonin et al., 2005a; Bonin et al., 2005b; Megginson, 2005. Alternatively, we acknowledge that other studies show that, in developed countries, foreign banks are not as efficient as domestic private banks (see DeYoung and Nolle, 1996; Chang et al., 1998). For a more detailed and well discussed summary of the foreign bank efficiency literature, see Berger, 2006.

[2] BCL subsequently added data from China in the full sample as the 153rd country.

[3] There is no literature to suggest whether one component in the monitoring index is more important than the others, so we choose to equally weight each component. Our results, however, are qualitatively the same when using other weighting schemes. For composition, we report only the equally-weighted results.