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BANKING SECTOR OPENING:
POLICY QUESTIONS AND LESSONS FOR DEVELOPING COUNTRIES

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Executive Summary

After decades of zealously protecting their banking markets, in the 1990s many developing and transition economies began to scale down or eliminate barriers to foreign direct investment (FDI) in the banking sector. Today, policymakers in a second wave of countries are in the early stages of opening their banking sectors or are under considerable political pressure to do so. Indeed, banking sector opening has been making headlines in recent months: The issue was hotly debated by U.S. and Russian negotiators during World Trade Organization (WTO) accession talks in 2006, India's government recently pledged greater opening of its banking sector by 2009, and the Chinese government has been selling significant equity stakes in some of the country's largest banks to foreign investors. Even smaller and less integrated economies, such as Vietnam and Libya, are currently preparing strategies for opening their banking sectors to foreign capital and competition.

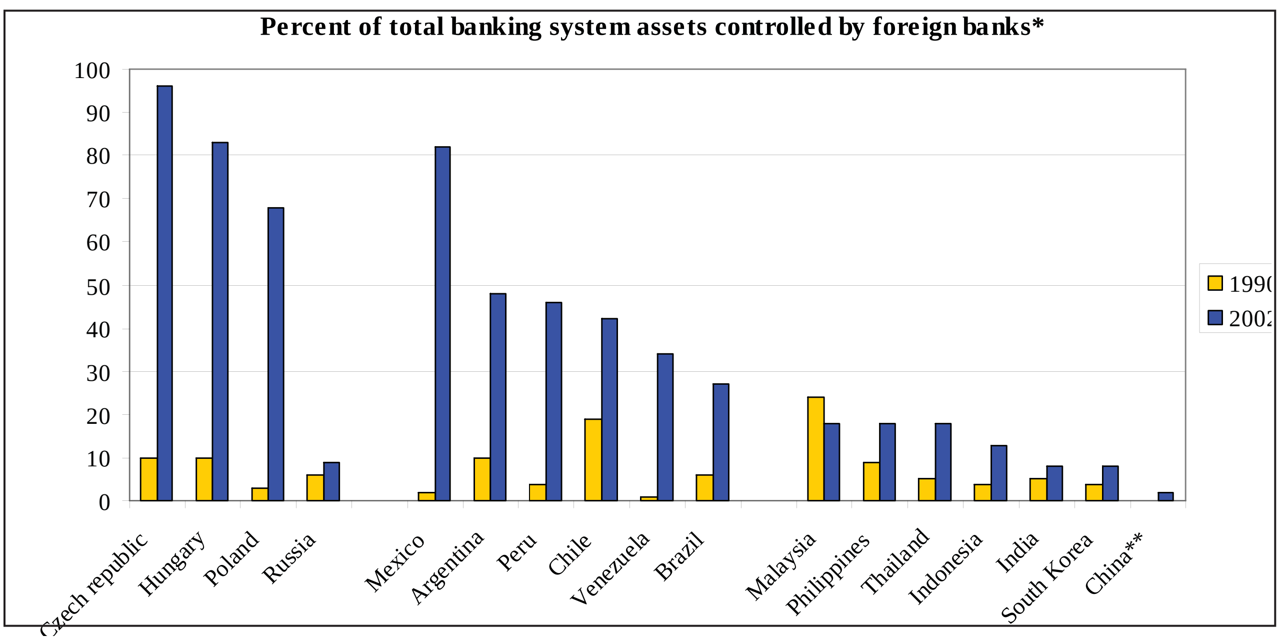
For developing country decision makers, this opening has raised urgent and complex policy questions. Banking sector opening can bring real benefits in the form of fresh capital, more competition, new financial products, and improved corporate governance, but it also can introduce new financial risks and vulnerabilities. This policy brief surveys the lessons and insights that developing country policymakers can draw from the academic literature and from the experiences of countries that have opened their banking sectors in the recent past.

The brief makes several recommendations. To ensure that foreign entry delivers the most benefits while introducing the least amount of risk, developing country policymakers should address the banking system's structural problems—particularly high levels of concentration—before or in parallel with the opening. They should also diversify the mix of foreign entrants and the ownership structures of acquired domestic banks, set out a clear division of labor between home- and host-country bank regulators, and learn from the financial authorities of advanced economies how best to deal with the challenges posed by foreign entry.

Falling Barriers

During the 1990s, long-standing barriers to foreign participation in banking fell dramatically in many transition and developing economies, particularly in the middle-income countries of Latin America, East Asia, and Central and Eastern Europe. These countries now allow foreign entry not only through new branches and subsidiaries (also known as *de novo* entry), but also through the acquisition of existing domestic banks. As a result, foreign capital has rushed into these countries, usually through the acquisition of existing domestic banks by foreign investors. The value of financial sector FDI in developing countries ballooned from $2.5 billion in 1991–95 to $51.5 billion in 1996–2000 and to $67.5 billion in 2001–5.

To be sure, the extent of opening and the volumes of banking sector FDI inflows have varied from region to region, as the graph below shows. Foreign participation, measured as the percentage of total banking assets owned by foreign-controlled banks, grew the most in Eastern Europe, with the notable exception of Russia. In Latin America, foreign participation increased from an average of 7 percent in 1990 to 47 percent a decade later. Opening was slower in developing Asia, where foreign participation levels stood at 12 percent in 2002. However, this number understates levels of foreign participation in the region because it shows only the asset shares held by foreign banks but not foreign nonbank firms, such as hedge funds and private equity firms. These nonbank firms have been particularly active in East Asia, acquiring troubled banks in the hope of restoring them to profitability.



Sources: Based on data from John Hawkins and Dubravko Mihaljek, The Banking Industry in the Emerging Market Economies: Competition, Consolidation, and Systemic Stability: An Overview, BIS Paper 4 (Basel: Bank for International Settlements, 2001), 25; and Committee on the Global Financial System, Bank for International Settlements, "Foreign Direct Investment in the Financial Sector of Emerging Market Economies," March 2004, 9.

* Foreign banks are defined as banks of which foreigners own 50 percent or more of the institution's total equity.

** The China statistic is for 1999.

What drove this wave of banking sector opening? Some governments opened their banking markets in the hope that foreign buyers would participate in the privatization of state-owned banks and help push up prices. Others did so in exchange for trade concessions at multilateral trade negotiations or to comply with accession requirements of the WTO. However, the single most important factor behind the opening in East Asia and Latin America was banking shocks. In a wide range of major emerging economies—from South Korea and Indonesia to Mexico and Brazil—the need to recapitalize crisis-afflicted banking sectors and sometimes to comply with IMF conditionality led to extensive banking sector opening in key emerging economies. In Central and Eastern Europe, pressure to satisfy European Union accession requirements appears to have been the decisive factor.

Major U.S. and European banks interested in cross-border expansion welcomed the liberalization of banking regimes with open arms. These institutions yearned to expand beyond the slow-growing, overbanked markets of the advanced economies and to tap the promising retail banking markets of developing economies. Hedge funds and asset-management firms also saw promising opportunities to purchase weak banks, restructure them, and sell them at a profit or benefit from the income streams of government-backed recapitalization bonds.

Today, a new wave of countries is either under considerable pressure to open the banking sector or is already in the early stages of opening. Some of these countries have recently made headlines. Banking sector opening was a hotly debated issue in talks over Russia's WTO accession in 2006, and Moscow remains under intense U.S. pressure to open its banking market. India has slowly been removing restrictions on foreign banks and has promised more opening by 2009. Meanwhile, the Chinese government—having committed to significant opening when it joined the WTO—is currently in the process of selling significant stakes in some of the country's largest banking institutions to foreign investors. Even smaller and less-integrated economies, including Vietnam and Libya, are currently designing strategies to open their banking sectors. Not surprisingly, financial authorities in these countries have started to ponder not just whether but also how to open their banking markets to foreign capital.

Policy Questions

The banking system is often said to act as the nervous system of an economy. Banks play a central role in the allocation of financial resources and manage most financial transactions. Because they are leveraged institutions, banks are inherently vulnerable to runs. Under certain conditions, the failure of a single bank can prompt depositors to flee from otherwise sound institutions and precipitate a collapse of the system. Therefore, opening the banking sector to foreign capital is a delicate operation that involves more complicated policy considerations than the opening of other service or goods sectors.

When considering how to open their banking sectors to FDI, host-country governments should consider four policy questions. Let us briefly consider each.

Impact on bank performance and governance. The first policy question is how foreign entry might affect how indigenous banks operate. Does foreign entry put competitive pressure on local players, forcing them to become more efficient and to lower interest rates on loans? The best and most recent research suggests that foreign entry does indeed make domestic institutions more efficient by forcing them to cut costs and to reduce the spread between the rate they charge borrowers for loans and what they pay depositors.

This is good news in the aggregate, but the results in specific countries depend on local conditions. The competition-enhancing effects of foreign entry seem to be greatest when foreign players enter *de novo* (that is, by opening new branches or subsidiaries) and into banking systems that are already moderately competitive. But when foreign entry takes place primarily through acquisition and into banking sectors that are controlled by a handful of large banks, the benefits do not materialize—fat domestic banks with market power are simply replaced by fat foreign-controlled banks with market power, and spreads and banks' cost structures tend to stay the same. A recent study of Mexican banking, for example, concluded that foreign-acquired banks, which now dominate the market, have not streamlined their cost structures because the system is so highly concentrated that the banks face insufficient market competition.

The impact of foreign entry on the corporate governance of banks is harder to evaluate, but the results here are mostly positive. Foreign banks are less likely to engage in related-party lending and to deliberately violate lending limits, primarily out of fear of getting in trouble with home-country regulators. The governance benefits may be greatest in countries like Indonesia, where selling off domestic banks to foreigners broke the tight links that existed between banks and business groups. This has reduced the political power of bank owners and should limit the banks' temptation to lend to a single business group on a preferential basis.

Impact on lending patterns. The second policy question is how foreign entry might affect the lending behavior of banks. The record so far suggests that what foreign banks do best in developing economies is consumer finance. Applying models finessed in advanced-economy markets, foreign entrants in Asia and Latin America have tapped mass markets hungry for mortgages and credit card and motorcycle loans. At the same time, these entrants have introduced a variety of fees, causing regulators and consumer protection agencies to grumble.

Less clear is whether foreign-controlled banks are better or worse than local banks when it comes to providing credit to businesses, including small- and medium-sized enterprises. One of the most sophisticated World Bank studies on the subject found that in Latin America, foreign banks generally provided less credit to small businesses than did local institutions. Meanwhile, the most comprehensive study on the question so far, a 119-country analysis by the Inter-American Development Bank (IDB), found no significant difference between the lending behavior of foreign-owned banks and private domestic banks in the period from 1995 to 2002. This study looked at lending across the board, not only at lending to small- and medium-sized enterprises.

The host country's level of development does seem to matter. According to researchers from the International Monetary Fund, in middle-income countries the impact of foreign participation on credit provision is mixed; but in low-income countries, foreign participation is associated with a contraction of credit to the private sector. In short, the record so far shows that the credit-enhancing effects of foreign entry should not be taken for granted.

Impact on financial stability. One of the most sensitive policy questions is how banking sector opening might affect the host country's financial stability. There are two issues here. First is whether foreign participation makes the banking sector less likely to experience a crisis. Theoretically, this should be the case because foreign-controlled banks face lower default risk by virtue of their globally diversified portfolios and lower funding costs. On the other hand, there is the possibility of "reverse contagion"—the risk that foreign banks may act as transmission belts for economic shocks from the home to the host country.

The second issue is whether, during an economic crisis in the host country, foreign-controlled banks will behave in a way that mitigates or exacerbates the shock. Because their parent institution is based abroad, a foreign bank should be able to inject liquidity into the banking system even when domestic banks are embroiled in the crisis and are forced to cut back their lending. Foreign banks could, in theory, act as lenders of last resort. Yet, because foreign banks operate their subsidiaries in the context of a global strategy, sometimes the parent institution may make decisions that are good for the parent but bad for the branch or subsidiary in the host country. This can exacerbate the shock. Host-country regulators also fret that, ultimately, a parent bank is under no legal obligation to rescue its troubled subsidiary and will walk away from it if the situation deteriorates. Domestic banks, on the other hand, cannot exit.

Because much of the foreign influx into developing countries' banking sectors took place after the financial crises of the 1990s and because there have been few crises since then, we have only a few isolated cases to test these propositions. Research on foreign banks in Malaysia and Eastern Europe suggests that rather than deserting their local operations, foreign banks have tended to expand credit supply during downturns. During the 2001–2 Argentine crisis, conversely, foreign bank portfolios proved to be just as vulnerable as those of local institutions, and three foreign banks abandoned their Argentine operations.

What we can safely say at this point is that whether a foreign bank will exit or stay during hard times depends on how the host country fits into the foreign bank's global strategy and whether the foreign bank can afford the reputational damage of abandoning the market in question. Foreign banks also react differently to different kinds of shocks. They appear to be a stabilizing force when shocks affect the local cost of funding, but they tend to overreact when the shock affects the investment opportunities available to the bank in the host country relative to opportunities elsewhere. This is what IDB researchers have called the "fickleness effect" of globalization.

Impact on capitalization. Finally, financial authorities must consider how foreign entry might affect the amount of capital held by the banking system. This question has special urgency in countries facing severe capital shortages after a banking crisis. Undercapitalized banks are unable to absorb their losses and may be unable to wind down their business without causing losses to depositors and counterparties, possibly disrupting the payments system. For this reason, banking authorities often make recapitalization a key precondition when selling a weak domestic bank to foreign investors.

In practice, foreign capital has played a positive role in banking sector recapitalization, especially in countries where domestic investors were unwilling or unable to inject capital or where the government was reluctant to use public funds for this purpose. In Mexico, for example, foreign banks injected some $8.8 billion between 1997 and 2002—the equivalent of 42 percent of the system's total capital. In Brazil, the government required European banks to inject hundreds of millions of dollars in fresh capital when taking over Bamerindus and Banespa, two of the country's largest financial institutions. This helped Brazil avert a systemic banking crisis in the mid-1990s and reduced fiscal pressure. In sum, so far recapitalization has been the clearest and most significant contribution that foreign entry has made to developing country banking sectors.

Policy Lessons

With these four policy questions in mind, what lessons can policymakers in emerging economies draw from the academic literature and from the experiences of the first wave of countries to open their banking sectors? How can banking sector opening be implemented in a way that maximizes the benefits but minimizes the risks? Five lessons stand out:

1. ***Opening will not solve structural problems.*** Foreign entry by itself should not be expected to transform a highly concentrated, uncompetitive banking system into one that provides more credit at lower rates. Foreign participation only yields benefits in banking sectors that are already moderately competitive; in highly concentrated or underdeveloped sectors, foreign banks have no incentives to act competitively and may in fact decrease credit to the private sector. These structural problems have to be dealt with separately, through a robust competition policy and through regulatory reforms, preferably before the opening of the sector. Also, *de novo* entry is more likely to help reduce sector concentration than entry by acquisition.

2. ***Choose the entrants carefully.*** Even when choosing among reputable institutions, not all foreign entrants are the same—the international banks and nonbank institutions that are actively investing in the financial sectors of developing countries have different time horizons, business strategies, and incentives. Large, global banks are more likely to have long-term strategies and to remain loyal to the local market during crises, whereas smaller international banks and hedge funds are likely to exit more quickly. Private equity funds, on average, have time horizons of five to six years from the purchase of a bank to the disposal of the asset. Hedge funds and private equity firms are also less sensitive than large global banks to reputational damage if they choose to exit a market. Finally, host-country authorities should also select entrants from a diversified mix of home countries to reduce exposure to banks from any single country or region. This should reduce the risk of reverse contagion.

3. ***Diversify ownership.*** When foreign investors enter a host market by acquiring existing domestic banks, they often delist the shares of their acquisitions and turn them into fully owned subsidiaries. The absence of domestic shareholders on the board of the subsidiary increases the chance that the parent bank may make decisions that are not in the best interests of the subsidiary. Delisting also deprives investors of valuable price signals and reduces market discipline of the bank. Requiring the foreign owners to list a substantial minority stake in the local stock market can help align the interests of the foreign-controlled bank with those of the host country. The governor of Mexico's central bank, for example, recently proposed that foreign bank subsidiaries be required to list at least 30 percent of their shares on the local stock market. In addition, because foreign and domestic banks react differently to different kinds of shocks, host-country authorities should ensure that their banking sectors include a good mix of both foreign and domestic banks.

4. ***Deepen regulatory cooperation.*** Transnational regulatory cooperation has not yet caught up with the globalization of banking. As a result, a crucial question remains unanswered: If a local

subsidiary of a foreign bank experiences liquidity problems, who is responsible for providing emergency liquidity—the host country's central bank or the central bank in the parent's home country? Home-country authorities will not relish the idea of using public money to support one of their banks' foreign operations, while the host-country authorities may find it politically difficult to use public funds to bail out a foreign bank. Asking this delicate question should not be postponed until a crisis hits; by then, regulatory squabbling will only make matters worse. Host and home countries should therefore develop cooperation frameworks now, going well beyond information exchange and outlining a division of responsibilities on how to deal with a troubled foreign subsidiary.

5. ***Learn from advanced-economy regulators.*** Finally, host-country authorities can learn much from their advanced-economy counterparts about how to cope with the regulatory challenges of foreign entry. For example, advanced-economy regulators can help with the supervision and regulation of derivatives and other sophisticated financial instruments that foreign banks may introduce in the host country, instruments that may be unfamiliar to the local authorities. Advanced-economy regulators also have more experience limiting fee escalation to protect consumers. Finally, developing countries could learn from the preference of many advanced-economy authorities to allow foreign entry through branches, not subsidiaries. Branches have important regulatory benefits, because they are less likely to engage in related-party lending and are more intensively supervised by the home-country authorities.

How to manage banking sector opening will remain an important policy challenge for developing countries for the foreseeable future. Recent academic research and practical experience suggest that foreign ownership of the banking sector is neither a straightforward cure for weak banking systems nor the neocolonial invasion feared by nationalist politicians. Foreign capital can be leveraged to strengthen the banking sectors of developing and transition economies, but how the opening process is managed is crucial. Policymakers' intelligent management of this process can mean the difference between a market opening that only produces quick profits for foreign banks and an opening that also strengthens the local financial sector and generates long-term benefits for the host economy.

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