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Rethinking regulation: international banks in Asian emerging markets

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Financial systems in Asian emerging market economies are in a state of transition. Through processes that began before the 1997 financial crisis in some Southeast Asian countries and gained momentum there and elsewhere after the crisis, countries in the region have opted for financial liberalisation to differing degrees. This state of transition has influenced assessments of the impact of the 2008 global crisis on the financial systems of these countries, especially the banking system in the region. If the focus is on the remnants of the pre-existing regulatory framework, the better performance of these banks during the crisis as opposed to those in other emerging markets can be attributed to the regulatory framework. If the focus is on the change that occurred after 1997, their resilience could be attributed to regulatory reform. One set of policies of relevance here is that relating to the presence of foreign banks in these markets, which is the concern of this paper.

In assessments of alternative forms of financial regulation that the 2008 financial crisis has prompted, systems prevalent in Asian economies have often been referred to favourably (Reddy, 2011; Standard & Poor's, 2008). The obvious reason is the relative resilience shown by these countries in the aftermath of the crisis. Initially, driven by the need to cover losses or meet commitments at home, foreign financial firms withdrew capital from Asian emerging markets, resulting in the threat of a liquidity squeeze and/or a currency crisis. But these economies withstood that shock and even bounced back, paving the way for a return

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of capital financed by the cheap liquidity infused into the system in response to the crisis in the developed countries.

However, the assessments referred to above, by focusing on what the prevailing regulatory frameworks had ensured, ignore the trend, as opposed to the moment, of the regulatory policies in many of these economies. While relative to many so-called emerging market economies (EMEs) elsewhere in the world (such as Latin America and Eastern Europe), financial liberalisation in some Asian economies is as yet limited, the direction of policy was and is toward further liberalisation. The intent clearly is to replicate the post-1980s Anglo-Saxon model, both in terms of financial structures and financial regulation.

Among the factors motivating this direction in policy was the desire to easily access foreign finance that seemed available in abundance, so as to relax the constraint set by potential balance of payments difficulties on development strategies. Since attracting foreign capital required attracting the carriers of that capital, the process of deregulation had to go beyond the rules that applied to cross-border flows of finance and the determination of exchange rates, to include those governing the operations of foreign financial firms in domestic markets. As in most of these economies banking dominated the financial sector, this implied relaxing the rules governing the entry of foreign banks, changing guidelines with regard to their activities post-entry and diluting the regulatory structure they were subjected to.

Overall, during what is considered the “second wave” of global financial integration that started in the 1960s (with the first dated between 1890 and 1930) (Battilossi, 2000), the relationship between international banks and developing countries has changed in two ways. The first, as in the previous wave of globalisation, was an increase in the acquisition of international claims by the banking system in emerging markets, involving cross-border flows of capital to both public and private sector targets. The second, was an expansion of the host country presence of international banks in emerging markets and an increase in deposit mobilisation and lending by local subsidiaries in local currencies.

However, as the Committee on the Global Financial System (CGFS) noted in a 2010 report (CGFS, 2010), the history of international banking

even in the period after the 1960s has seen some kind of structural shift. It is in the period from the mid-1980s that there has been an increasing emphasis on the creation of branches and subsidiaries in developing countries, with a focus on retail business. This has been true in Asia as well.

There are a number of noteworthy features of this recent period. One is the substantial increase in the international assets of the big banks of the developed world. At the time of the East Asian crisis (end of June 1997), 23 countries reporting to the Bank of International Settlements, reported that the international asset position of banks resident in those countries stood at $9.95 trillion, involving $8.6 trillion in external assets after adjusting for local assets in international currencies (Bank of International Settlements, Monetary and Economic Department, 1997). By June 2007, when 40 countries were reporting, this had risen to $33.71 trillion, with external assets totalling $29.98 trillion (Bank of International Settlements, 2007). This expansion in the international asset position was not only the result of the increase in the number of reporting countries.[1] The trend was visible in countries that reported on both dates as well. Thus, the international assets of UK-based banks had increased from $1.5 trillion to $6.1 trillion, and that of US banks from $0.74 trillion to $2.8 trillion.

Second, while there was a close relation between the ratio of international trade to GDP and the international claims of banks relative to GDP till the end of the last century, subsequently there has been a sharp divergence, with bank claims racing ahead of trade. If trade had led or, at least, significantly influenced financial flows earlier, that seems to be much less true more recently.

Finally, there is evidence that the activity of financial capital has acquired a degree of independence with a weakening of its relationship with the trends in the real economy. An important element of the evidence is the much faster growth in the volume of financial assets when

[1] Very often, countries that were not reporting have been characterised by small or negligible international exposure of banks operating from within their borders. There have been exceptions, such as the Republic of Korea that joined the countries reporting to the BIS only in 2005.

compared with real output and real wealth in many economies. This was partly the result of the emergence and growth of securities and derivatives markets, which has led to a substantial lengthening of intermediation chains, an increase in the number of layers of intermediation and the creation of new institutions and instruments.

These trends were visible in the emerging markets as well. Overall, even though the exposure of international banks in developing countries is only a fifth of that in the developed, that exposure has in recent years traversed from a relative flat trajectory to a steeply rising one. Associated with this accelerated inflow of banking capital was an increase in international bank presence in developing countries.

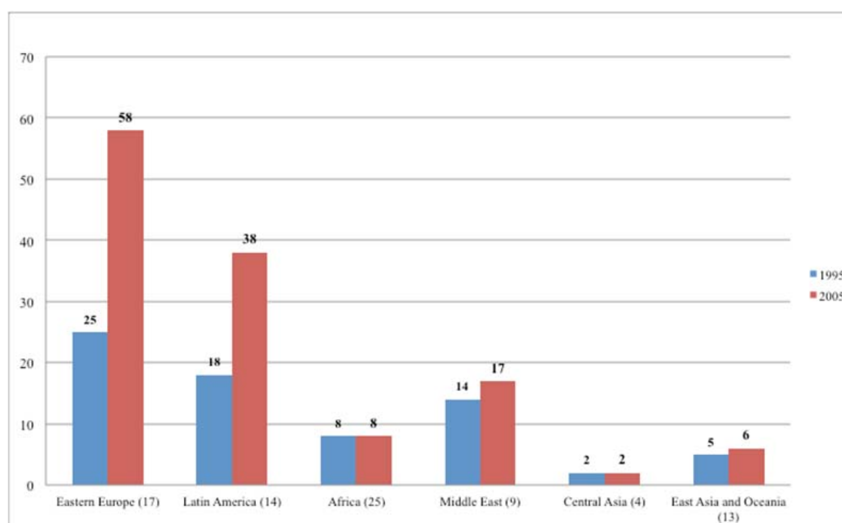
Among the many reasons cited as explaining the desire of banks to establish a physical presence in emerging markets three are of particular relevance. These are: (i) a combination of increased competition and saturating business opportunities at home; (ii) increased access to enhanced liquidity at low interest rates as a result of monetary easing; and (iii) greater liberalisation, better profit conditions and improved security in EMEs. These are important because they point to the role of supply side decisions in driving foreign bank expansion and presence in emerging markets.

1. Foreign bank presence

As a result of these processes, an IMF study found that between 1995 and 2005 the share of foreign banks in total bank assets in developing countries rose from 25 to 58 per cent in Eastern Europe and from 18 to 38 per cent in Latin America, though even by that date the increase in East Asia and Oceania was much less (from 5 to 6 per cent) (figure 1). However, the trend has been visible in Asia as well more recently.

Not surprisingly, with this increase in presence, the share of foreign banks in lending to non-bank residents has been rising. Since the mid-1990s (and by 2009) the share of foreign banks in credit to non-bank residents rose from 30 to 50 per cent in Latin America, to nearly 90 per

Figure 1 – *Foreign bank ownership: ratio of foreign bank assets to total assets, %*



Source: International Monetary Fund (2007), table 3.2.

cent in emerging Europe, and stood at about 20 per cent in emerging Asia.

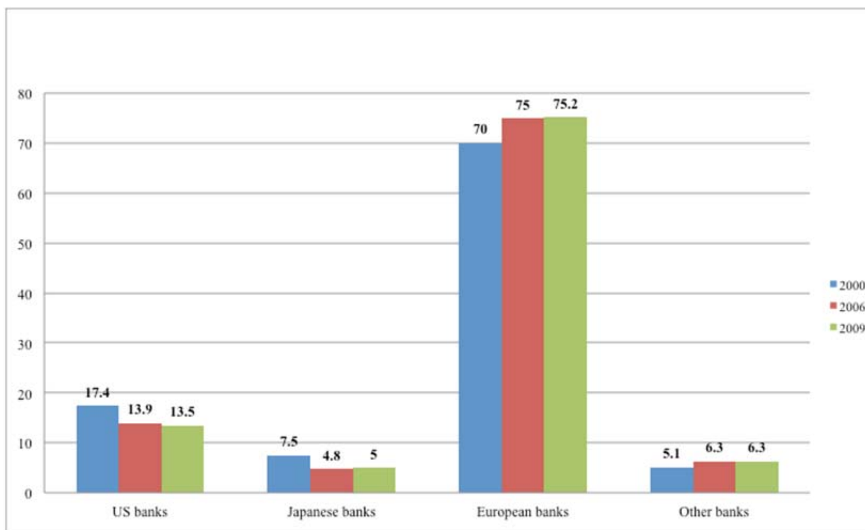
A second feature of the recent focus on emerging markets is that the international banks involved are predominantly European. Around three fourths of foreign claims in developing countries is on account of European Banks (figure 2). Part of the reason is that mid-sized European banks faced with increased competition at home are now seeking out developing countries to expand business and sustain profitability. The concentration of EME exposure in a few banks from one region increases the vulnerability of both these banks and their clients.

A third feature is that banks are no more targeting their lending either to governments or international corporations investing in developing countries. Rather their focus is increasingly on retail lending, in the form of housing-related and other personal lending. As a result, the share of non-bank private sector borrowers in the portfolio of foreign

banks has grown from about 25 per cent to more than 60 per cent of claims over the 1985-2009 period (CGFS, 2010). Public sector borrowers now account for only 15 per cent of total international claims on developing countries, as compared to more than 40 per cent of two decades ago.

Finally, the increased presence of these foreign banks has been accompanied by a substantial increase in their activity in wholesale markets, including securities and derivatives markets.

Figure 2 – *Location of foreign claims in developing countries by nationality of reporting banks (%)*

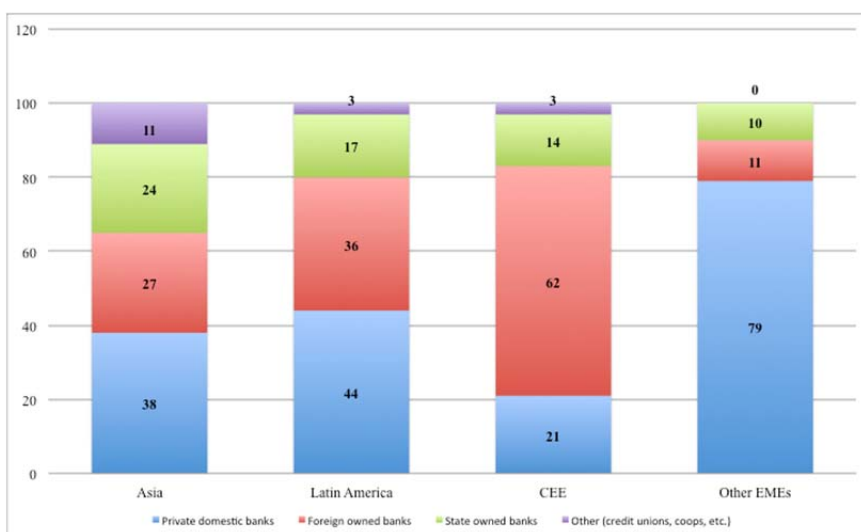


Source: Bank of International Settlements (2007).

Given this background, the liberalisation of the more stringent rules governing the entry and operation of international banks in Asian economies was bound to have a significant effect. That Asian economies were far less liberalised and open than many of their Latin American and East European counterparts is reflected even today in a number of

features of their financial systems. To start with, the average share of banking assets held by foreign banks has been significantly lower in Asian emerging market economies than it was in Latin America and substantially lower than in Central and Eastern Europe (figure 3). Further, evidence at a more disaggregated level indicates that other than Singapore and Hong Kong, which chose to serve as regional financial hubs, individual Asian countries were at the lower end of the distribution in terms of share of foreign banks in banking assets (figure 4).

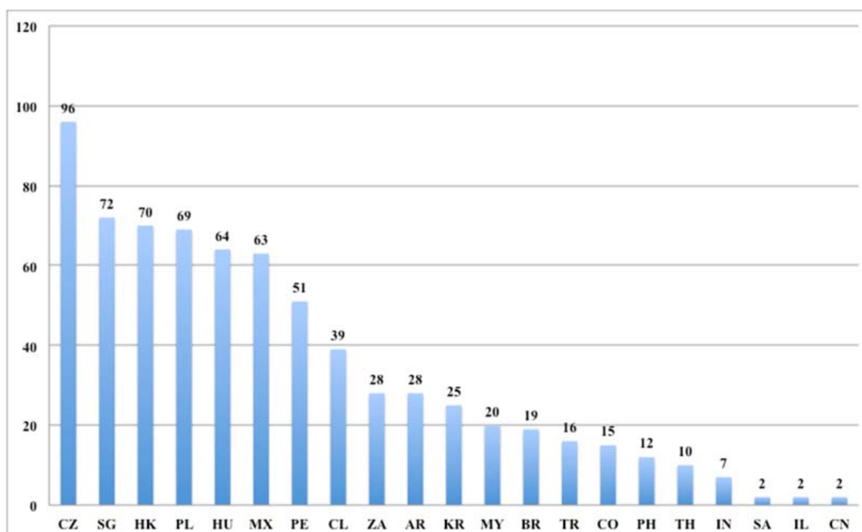
Figure 3 – *Ownership structure of emerging market banks, as a percentage of total banking system assets*



Source: Bank of International Settlements data, based on responses to questionnaire from central banks, reported in Mihaljek (2011).

Underlying this limited penetration of foreign ownership into the Asian banking system was prevalently policy. While in most countries regulation capped the level of foreign shareholding in individual banks (see table 1), in others such as Indonesia, procedures constrained acquisition , which is the favoured route to foreign bank ownerships in

Figure 4 – *Assets of foreign owned banks, as a percentage of total banking system assets*



Note: AR = Argentina, BR = Brazil, CL= Chile, CN = China, CO = Colombia, CZ = Czech Republic, HK = Hong Kong SAR, HU = Hungary, IL = Israel, IN = India, KR = Korea, MX = Mexico, MY = Malaysia, PE = Peru, PH = Philippines, PL = Poland, SA = Saudi Arabia, SG = Singapore, TR = Turkey, TH = Thailand, ZA = South Africa.

Source: Bank of International Settlements data, based on responses to questionnaire from central banks, reported in Mihaljek (2011).

emerging markets. Moreover, investor opinion was that bank stakes in these countries are extremely costly to acquire -- a view corroborated by the heightened pace of acquisition after the Southeast Asian crisis, for example, when bank valuations fell significantly (KPMG, 2011).

However, as noted above, while this has influenced the current level of foreign ownership in the banking sector in Asia, the direction of policy in most countries of the region was towards relaxing the terms of foreign entry and encouraging foreign bank presence on the grounds that this would enhance competition, improve "productivity" and lead to better service quality. This has expanded foreign presence, largely through acquisition.

According to a study by the CGFS: "[t]he proportion of cross-border M&As in East Asia's financial sector initially was small compared with other regions. The value of cross-border M&As targeting non-Japan Asian countries was $14 billion or 17% of the total during 1990-2003. Asia, however, has been one of the fastest growing target regions for M&A, with a sizeable jump in cross-border M&A activity occurring in Korea and Thailand. In addition, there has been a large number of small-value cross-border M&A transactions in the finance sector between East Asian economies. In 2003, Asia received the largest share of FSFDI inflows." (CGFS, 2004, p. 5). Thus, there is evidence that even Asia, where thus far the absolute share in banking assets of foreign firms is still low, has been experiencing an increase in foreign presence especially after the 1997 crisis.

As the CGFS study notes: "[a] standard response to crises by EME governments, encouraged by the international financial institutions, was to accelerate financial liberalization and to recapitalize banks with the help of foreign investors. This was the case in Latin America in the years following the 1994 Mexican crisis." (*ibid.*, p. 6). In Asia also, most governments liberalized the terms of foreign entry and ownership after the 1997 crisis.

These developments notwithstanding, the perception that foreign ownership has been limited by policy in Asian countries has coloured academic assessments (Montgomery, 2003; Milo, 2002) of the region. In the event, two consequences of the expansion of foreign ownership have tended to be ignored. The first is the effect it is having on the effectiveness of domestic regulation, partly because foreign banks operate through branches or subsidiaries, and partly because of the influence of global strategies on the functioning of their affiliates. The second is the impact that the very different operating practices of the financially much stronger foreign banks have on the mobilisation of domestic deposits and the allocation of credit.

2. Regulatory failure

Developments in some Asian emerging market economies illustrate the first of these consequences. Early in May 2011, India's central bank, the

Reserve Bank of India, issued an unusual set of guidelines for foreign banks operating in the country (Reserve Bank of India, 2011). The notification stated: "[i]t has been decided that for all foreign banks operating in India, the CEO (chief executive officer) will be responsible for effective oversight of regulatory and statutory compliance as also the audit process and the compliance thereof in respect of all operations in India."

For those accustomed to normal principles of corporate governance this official notification must come as a surprise. Who other than the CEO of a company would be finally responsible for compliance? The RBI, however, had a reason to state the obvious, based on allegations of fraud in branches of banks such as Citibank and Standard Chartered Bank. "It is observed," it noted, "that Indian operators of foreign banks functioning in India as branches of the parent banks generally do not have a separate audit committee vested with the responsibility of examining and reviewing inspection/audit reports for their compliance." As a result in its view: "[i]n the recent past there have been concerns about the adequacy of regulatory compliance by foreign banks in India and it is felt that this is on account of business heads and units reporting directly to their 'functional heads' located overseas and not to the CEO of Indian operations."

To deal with this, the RBI is also contemplating institutional requirements that would improve regulatory oversight. As opposed to allowing foreign banks to function through "branches" of units registered abroad, it is expected to soon require foreign banks to operate in India through wholly owned subsidiaries registered in the country. This would make the bank's Indian structure an Indian entity and facilitate regulation.

Among the instances cited to show how foreign ownership adversely affects domestic functioning is the arrest in January 2011 of a Citibank relationship manager. He was charged with luring affluent customers to invest in fraudulent schemes ostensibly backed by the bank and offering high returns, leading to losses estimated at more than $65 million (Raval, 2011). The problem is not restricted to India. In April 2011, Indonesia experienced a similar instance of fraud in which a relationship manger allegedly spirited $2 million from the accounts of customers (Deutsch and Guerrera, 2011). In response, the Indonesian central bank banned Citibank from canvassing new premium customers for a year. Earlier, in October 2010, small and medium

exporters in South Korea demonstrated in front of the Citibank headquarters in Seoul and threatened to boycott foreign banks, because they had been improperly briefed and misled into investing in "knock-in, knock-out" derivative contracts[2] as a hedge against currency fluctuations.

What is noteworthy is that, provoked by experiences of the kind noted above, the Indonesian central bank is contemplating changing rules with regard to foreign ownership, including reducing the cap on foreign equity ownership from 99 to 50 per cent. The deputy governor of Bank Indonesia, reportedly stated that: "[t]he objective is clear: to promote good corporate governance and strengthen control of banks." (Sender and Deutsch, 2011).

These instances among others challenge the notion that the entry of foreign banks, by both inducing competition and setting an example, improve governance and enhance the efficiency of indigenous banks in developing countries. Foreign banks are expected to introduce into the host countries best practices and new technologies. Further, as the proponents of financial liberalization assert, the entry of foreign banks would enforce market discipline, improve the efficiency of domestic banks, and thereby strengthen financial intermediation and the supply of credit (Fry, 1988). The "efficiency" argument, where efficiency is equated with profitability, is not our concern here. What is more important are the implications of foreign bank presence for the banking system's provision of crucial services such as debt-intermediation and risk-bearing.

Even here the record of foreign banks in emerging markets is by no means positive. They are known to focus on activities like provision and syndication of foreign currency loans or arranging acceptances and guarantees related to international trade for select clients, such as multinational corporations, large domestic corporations, and high net worth individuals. Retail banking services such as small savings accounts, small-sized mortgages, or provision of small business loans are hardly emphasized by foreign banks. In the event, in the past the loan ratios of foreign banks tended to be lower than the domestic banks.

[2] These required them to sell dollars at a fixed exchange rate if the Korean won moved within a range set out in the contract, or to sell dollars below the market rate if the exchange rate moved outside that range (Jung-a, 2010).

Table 1 – *Essential rules governing foreign ownership in the Asia-Pacific*

CHINA

China limits the share of a single foreign investor in a Chinese bank to 20 per cent, and will treat the entire bank as foreign if more than 25 per cent is in non-Chinese hands. Some countries complain that it had not specified limits on foreign ownership in the conditions it accepted on accession to the World Trade Organisation in 2001.

MALAYSIA

Malaysia caps foreign ownership of local banks at 30 per cent. It is reported to be reviewing this to allow foreign investors to own up to 49 per cent.

INDIA

Foreign ownership of India's private sector banks is not allowed to exceed 74 per cent of paid-up capital with individual foreign institutional investors' holding capped at 10 per cent. Foreign banks operating in the country are required to function as branches of parent firms headquartered abroad. However, the Reserve Bank of India is considering allowing them to operate as wholly-owned subsidiaries.

INDONESIA

Allows foreign entities to hold up to 99 per cent of local banks. Any single entity trying to own 25 per cent or more of the total shares needs approval from the central bank. The 99 per cent cap is currently under review.

THAILAND

Foreign banks can own up to 25 per cent of a Thai bank without seeking approval from the Bank of Thailand. Owning between 25 and 49 per cent requires approval by the Bank of Thailand. Foreign ownership in excess of 49 per cent is subject to approval by the Ministry of Finance. A single investor must also receive approval from the Bank of Thailand if the shareholding exceeds 10 per cent.

SINGAPORE

A single shareholder requires permission of the minister in charge of the central bank to increase shareholdings in a local bank at 5 per cent, 12 per cent and 20 per cent thresholds. If the government approves, foreign banks or other entities can own 100 per cent equity in a Singaporean bank.

SOUTH KOREA

There is no specific limit imposed on foreign stakes in banks. But as per the local banking law, a financial player (domestic or foreign) is allowed to hold up to a 10 per cent stake in a bank without approval and can become the majority stakeholder in a bank. However, a non-financial player cannot own more than 9 per cent.

Source: Reuters Hong Kong, 2 August 2011; available online at the URL http://in.reuters.com/article/2011/08/02/idINIndia-58571120110802 (last accessed 14 August 2011).

3. Behavioural change

However, recent evidence shows that foreign banks are changing their behaviour and both mobilizing deposits as well as providing loans to domestic customers (CGFS, 2010; Rashid, 2011). But even when this happens the focus of their activity is not firms or other agents engaged in productive activity, but the retail banking sector, involving loans for housing, automobile purchases or consumption. What is more, the evidence suggests that the entry of multinational banks sets in motion processes that force domestic banks to adjust their portfolios in line with these banks. But, foreign banks are in a position to “cherry pick” the best customers (low cost, low risk), leaving domestic banks with borrowers of lesser quality. As a result, both the costs and credit risks of domestic banks increase. Domestic banks in order to remain competitive need more capital to invest in new technology. The need for capital, coupled with the loss of the prized customers, creates tendencies towards asset switching — away from traditional lending into fee-based income, investments in government securities and loans based on standardized balance sheets — which also serves to shore up the risk-weighted capital ratios among the domestic banks, particularly as regulatory standards become more stringent. Banks that resist this change tend to be saddled with more risky loans and higher non-performing assets, which makes them ideal candidates for takeover by the multinational banks. Dymski (2004) notes that a consequence of these changes in the credit markets is that banks that seek to operate differently from the elite multinational banks tend to lose customers and profits. The result is that they are forced to sacrifice some of the characteristics that have made them institutions suited to support industrial growth.

Hamid Rashid (2011) points to more complex ways in which foreign banks’ operations can affect credit provision in emerging markets, especially when those banks mobilise local resources and lend in local currencies. Based on bank level data from 81 developing and emerging countries he points, *inter alia*, to three important trends. The first is that increasingly foreign banks are displacing domestic banks in the market for deposits. Not only is the deposit share of foreign banks significantly

higher than that of domestic banks, but also the rate of growth of deposits with foreign banks' is higher than for domestic banks. The second is that behaviourally foreign banks are different from domestic banks, displaying a lower average loan-to-asset ratio and an asset portfolio with a higher share of non-lending, high-return activities such as investments in securities and trading activities. This means that a larger share of deposits go to support such activities. Third, as foreign banks increase their share of deposits, domestic banks are forced to increase their reliance on non-deposit-based funding to finance their lending (and non-lending) activities. However, the higher costs and uncertainty associated with non-deposit-based funding force domestic banks to reduce their lending activities. Overall, credit availability tends to get squeezed, and inasmuch as other evidence shows that foreign banks prefer retail to productive lending, this would adversely affect lending for investment purposes in particular.

A further consequence of foreign bank presence highlighted by the recent global crisis is the transmission of global shocks to emerging markets. If foreign banks are an important source of funding for households and corporations in these markets, developments abroad that adversely affect the liquidity position of banks – such as a credit squeeze, worsening capital positions or more restrictive lending standards – can affect access to credit in emerging markets, such as those in Latin America (Kamil & Rai, 2010).

In addition, financial integration results in a supply-side push of international banks into developing countries in two senses. It involves, as in the past, an increase in capital flows into developing countries, which is determined by liquidity and structural conditions in the developed countries. It also involves the creation of branches and subsidiaries of foreign firms in developing countries, to expand business beyond what can be undertaken only with capital from the home country. One implication of these developments is that the presence of these institutions imports into the "emerging markets" the practices and instruments associated with the process of financial innovation in developed countries since the mid-1980s. Local institutions too begin to adopt these practices and stay with them even when events such as the

recent financial crisis suggest that they render the system fragile and crisis-prone. This obviously means that the regulation in developing countries must either be geared to limiting foreign presence in their banking sectors or dealing with new institutions, instruments and practices. The recent moves of the Indian government indicate that while it has chosen to relax restraints on foreign entry, it is yet to devise an adequate regulatory framework to deal with the resulting brave new world.

4. Cross-border vs. domestic lending

There is a strand in the literature that suggests that it is not the presence of foreign banks *per se*, but the nature of their presence that determines vulnerability. In particular, it is argued that the propagation of global financial shocks "is significantly more muted for countries where foreign banks conduct a higher share of their lending in domestic currency" (Kamil and Rai, 2010, p. 4). Based on a study of countries in Latin America and Caribbean, Kamil and Rai argue that the nature of the involvement of foreign banks in this region differs fundamentally from elsewhere, especially in emerging Europe.[3] They conclude: "[f]oreign banks conduct a higher share of their lending in the LAC region through local affiliates, which appears to reduce the risk of a homeward flow of foreign banks' assets. In addition, much of the funding of foreign-owned

[3] To quote Kamil and Rai (2010): "following the Lehman demise in the third quarter of 2008, lending by foreign banks to the LAC region slowed rapidly, amid the freezing of global money markets and doubts about the health of banks in advanced economies. Most of this deceleration in foreign banks' total credit growth, however, reflected a sharp contraction in cross-border loans to LAC, which are largely denominated in foreign currency and funded in wholesale markets. On the other hand, lending by local affiliates of foreign banks—which is mostly denominated in local currency and funded with domestic deposits—proved much more resilient and continued to expand, even amid the global turmoil. Because such claims by local affiliates represent almost 70 percent of all foreign banks' claims on the LAC region, total foreign banks' lending to LAC actually increased slightly between 2008Q3 and 2009Q2 (when measured at constant exchange rates). This contrasts markedly with the behaviour of foreign banks' claims in emerging Europe, emerging Asia and Africa and Middle East, which declined over the same period." (p. 4).

subsidiaries in Latin America has come from domestic sources, i.e., from an expanding deposit base, rather than from parent banks' resources (or from wholesale funding). This reduces the vulnerability to a sudden withdrawal of short-term external funding. Moreover, global banks with the largest presences in LAC markets have low exposures to emerging Europe, so that Latin America is not likely to be susceptible to a credit pull-back similar to, or feeding off, strains in emerging Europe. Together, these features of foreign banks' operations in the LAC region reduced the extent of contagion from the international liquidity squeeze." (p. 4).

Thus, financial liberalisation of the kind that encourages foreign banks to establish a physical presence and mobilise and lend local currency resources is seen as more appropriate than liberalisation that merely eases conditions for the cross-border movement of capital. But by focusing on the possible withdrawal of liquidity due to extraneous reasons, which is obviously likely only when lending is cross-border and in foreign currencies, Kamil and Rai may be missing out on more direct ways in which foreign bank strategies can influence access to credit in developing countries, especially for productive investment.

Thus developing countries would do well to tread with caution when attempting to liberalise policies with regard to the entry into and operation in their economies of foreign banks. While arguments varying from the benefits of increased competition to access to better technologies and management practices may motivate such action, there are a range of other outcomes that need to be factored in. In particular, not only could the behaviour of these banks be very different from what would be appropriate at the levels of development in these countries, but their presence could also transform the behaviour of domestic banks that may be forced to imitate their foreign competitors.

Further, financial liberalisation that attempts to attract the carriers of foreign finance in a bid to access international liquidity, could lead to challenges that conventional regulation does not address. These challenges involve not just the instability associated with cross-border flows, but behavioural characteristics and situational responses that increase instability due to structural or institutional causes. These changes soon come to characterise domestic institutions as well, making

regulation far more difficult to implement. On the other hand, the effort to attract capital and institutions from abroad encourages deregulation and regulatory forbearance. This holds a lesson for developing countries. They should not only consider restricting capital inflows with controls, but also the entry of foreign firms that are the carriers of that capital.

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