# Implications of the Globalization of the Banking Sector: Discussion

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The *Financial Times* recently reported that the largest brewer in England was about to fall into Belgian hands. Bass Brewing was being acquired by Belgium's Interbrew for the princely sum of $3.45 billion. With this transfer of ownership, 220 years of brewing under British ownership was about to come to an end. As a result, half of the British beer industry was now going to be in foreign hands, something the FT described as "unthinkable a few years ago." Similarly, not long ago the British hunting and shooting magazine, *The Field*, lamented the purchase of Britain's oldest and most elegant shotgun manufacturer by a French firm. It seems that nothing in the commercial world is sacred anymore!

Ownership of large or prestigious enterprises by foreigners is something that goes down hard in most countries, never more than in banking. But the reasons differ. Banking institutions have been and continue to be central to economic development, even in countries with well-developed capital markets.[1] The greater the information and monitoring problems in lending, the greater has been the role of banks. This is especially true for small and medium-size firms without access to capital markets and where information is "impacted" and difficult to credibly transfer. Banks have also been central to the direction of economic development by governments, to the protection of nonbank firms from foreign takeover, to the sharing of risks with commercial and nonbank financial firms, and, sadly but true enough, to the intricate and pernicious web of relationships with politicians in search of illicit financing. Banking in

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[1] See White (1998) on the role of banks in U.S. economic development.

some countries is treated almost like the defense industry: best to have it in domestic hands.

Following on from a number of interesting papers related to banking and financial stability, Joe Peek and Eric Rosengren take up the issue of the benefits of opening domestic banking markets to foreign institutions. One of their central propositions is that once foreign banks have a brick and mortar presence in a country they act more like domestic banks. They are less likely to flee in the event of a crisis. Well-capitalized foreign banks might even act as a "safe haven" during crisis periods, reducing capital flight. Peek and Rosengren attempt to provide evidence for this proposition by looking at the recent experience of foreign bank lending in three Latin American countries. They conclude that foreign bank penetration did not decrease after recent crises, while offshore lending did. Ergo, presumably, the more the better.

## Finance and Institutional Change: The Costs and Benefits of Foreign Entry

In discussing the benefits of foreign bank entry, we need to ask ourselves whether we are implicitly talking about a comparison of two equilibria or the movement from one equilibrium to another. The "better equilibrium" is that of a more efficient and more stable banking system, where stability comes from the combination of plentiful capital to absorb unexpected shocks, a competitive environment, good credit analysis and monitoring skills, and proper banking supervision. But how to get from here to there without major disruption is rarely obvious.

Major institutional change is difficult and in banking often costly. Countries that chose a slow path to financial liberalization (Japan), countries that deregulated rapidly (Sweden), and countries that deregulated faster than they desired because of foreign pressure (Korea) have all gotten into difficulty. What we have learned is that, in finance, old habits die slowly, no matter what the "financial regime." As Armen Alchian (1950) argued a half-century ago, individuals and enterprises, particularly when confronted with uncertainty and a changing environment, often adopt behavior patterns similar to what they used to achieve success in the past. And they get into trouble, not only because old dogs do not learn new tricks quickly but because sometimes they are not really sure how they did them in the past.

Governments in developing and transition countries usually know what kind of banking system they desire but are often uncertain of the best path to get there. As Stijn Claessens (1996) has put it, these countries can try to reform existing institutions, the "rehabilitation approach," or try the "new entry approach" and invite in foreign banks, or try a combination of the two. Displacing an unstable banking equilibrium with foreign entry is certainly one way to force domestic intermediaries to

learn new tricks, to put pressure on local banks, and, it is hoped, to increase both efficiency and stability. But it is not at all obvious, certainly not as obvious as Peek and Rosengren appear to think it is, that foreign entry will always do the trick. In looking at the pros and cons of "global banking" (both direct entry and cross-border interbank lending), Federal Reserve Governor Roger W. Ferguson, Jr. (1998) has reasonably argued that it could just as well stimulate capital flight. Foreign banks, even those with a brick and mortar presence, may be only marginally committed to their host country. He also argued that foreign banks may add to pressures to deregulate more broadly than the domestic market can absorb without disruption. Liberal-minded folks always come out on the side of greater entry for an industry being more desirable than less. So too in banking. Hence we almost always find ourselves on this side of the argument. And just as often, as evidenced by recent financial crises in both developed and developing countries, we are surprised that the free spirit of private enterprise can, without the prerequisites like proper accounting standards and credible, enforceable, and enforced financial laws, lead to as much turbulence as in more inefficient and crisis-prone financial systems.

As recently shown by Levine, Loayza, and Beck (2000), the efficiency of the functioning of financial intermediaries and their contribution to economic growth depend to an important extent on the quality of the legal and regulatory system, particularly on contract enforcement (creditor rights) and information disclosure (the "accounting environment"). To the degree that foreign bank entry encourages this development, so much the better. But because of the difficulty of conducting banking business when these prerequisites are not available, foreign banks may find themselves with the same difficulties as domestic ones. Thus, my first criticism of the Peek/Rosengren paper, even if I am sympathetic to their arguments, is that it may leap a bit too quickly at the benefits of foreign entry without looking under the carpet and examining the risks.

One risk is that the increased competition may seriously weaken already wobbly domestic institutions.[2] Fine, you say, all the better. But, many of these institutions may be covered by an implicit or explicit safety net, and widespread failure may simply not be "affordable" to the Treasury, not to mention the potential for political instability. We should be aware of the pressures on the safety net that may result from a sudden increase in competition for weak domestic intermediaries, particularly if they are large.

In some countries banks play a major role in risk-sharing with other

[2] Claessens, Demirguc-Kunt, and Huizenga (1998) show in a study of 80 countries that while foreign bank entry improves banking markets, it also reduces the profitability of domestically owned banks.

intermediaries and nonbank enterprises, such as they did in Japan for many years with the keiretsu system of risk-sharing and quality control, and with great success. Foreign entry, while desirable in the long run, may be costly and, if too rapid, inefficient in the short run. Risk-sharing between the private and public sectors was a major component in Japan's economic development. Arguably, this may have led in some cases to a "no-failure norm," as suggested by Milhaupt (1999). At one time this was, in his view, "justified" given the strategic role of banks in the Japanese economy as the warehouse of borrower-specific information, which could not be easily transferred to other potential lenders. The implicit safety net, whatever we may think of it today, worked very well and was a central part of the credibility of the financial system. The problem was how to get to the new equilibrium—one without a "no-failure norm" mentality—without major financial turbulence. Obviously, it has not been easy.

There are clear reasons why, for many years, a number of countries did not encourage a major foreign bank presence. For several of them, when they did, it was out of dire necessity, not sudden economic enlightenment. They needed the capital. Ravaged by banking crises, some countries have opened up their banking markets to foreigners because of the paucity of domestic capital and the need to improve the quality of domestic credit allocation. Peek and Rosengren point to Mexico, where the government eased restraints on foreign acquisitions in order to inject capital into domestic banks. Similarly, foreign banks appeared more palatable to Argentina after the Tequila crisis. At the same time, the risk remains that foreign banks will be able to attract the best-quality borrowers, leaving the poorer ones for domestic institutions. Foreign banks may be induced to enter because, first, in some cases, given a similar culture and language, they see major long-run opportunities because of the lack of strength of domestic institutions, and, second, because they have not yet been burned.

For some countries, foreign entry may be permitted because it may be seen as the lesser of two evils. Several years ago, it was recognized that the Italian banking system was in need of privatization and a major capital injection. Two alternatives were available, neither very attractive to some: foreign ownership or ownership by domestic nonfinancial enterprises. As seen in that country, the choice has not been an easy one to make.

One reason a small set of countries have recently been more receptive to major foreign bank entry is their exchange rate system, in particular currency board arrangements that limit the lender of last resort function of the central bank. In these countries it is also observed that bank capital requirements are higher than international standards, necessitated by the need to make certain the banking system can absorb big external shocks. Consider Argentina. To provide banks with greater liquidity, several years ago unremunerated reserve requirements were converted to remunerated ones. In 1996 the central bank obtained a large

contingent repurchase facility with international banks, for use should a liquidity crisis emerge. And bank capital ratios were sharply raised. The Tequila crisis, as Peek and Rosengren note, pushed Argentina to privatize more banks and make them available to foreigners. With 40 percent of deposits now in foreign banks, confidence in the currency board arrangements has likely improved.

While it is generally recognized that some foreign bank presence is desirable, two questions are difficult to answer: how to do it without seriously weakening domestic institutions and endangering the domestic safety net, and at what point a foreign banking presence is "too much." Promoting foreign bank entry, along with privatization of publicly owned banks, may also be a desirable way to reduce the "risk-shifting" from the private to the public sector. Brock (1998) has argued that earlier efforts at financial liberalization in Latin America, Argentina, and Chile in the 1980s, and Venezuela and Mexico in the 1990s, were supported by well-recognized implicit government guarantees of bank creditors. In some cases the recognition of these implicit guarantees increased the risk preferences of both banks and their creditors, eventually with costly consequences for governments. Reducing the safety net may over time be easier with foreign banks in competition with domestic intermediaries.

## But Will They Run?

Peek and Rosengren conduct a considerable amount of statistical work to get a good picture of foreign bank lending in Argentina, Brazil, and Mexico, using standard sources plus some difficult-to-obtain data on lending by foreign subsidiaries from BIS non-reporting countries. They come up with some interesting observations: (1) There has been a considerable increase in lending into Argentina and Brazil by non-reporting subsidiaries (there are none in Mexico); (2) recent crises do not seem to have greatly deterred lending by foreign subsidiaries in Argentina, Brazil, and Mexico; and (3) "offshore lending appears to be somewhat more sensitive to economic instability than onshore operations."

Can we conclude that foreign subsidiaries are likely to provide greater stability to these countries' banking systems than cross-border lending? I think the answer is a tentative "yes." However, this comment is as much a reaction to the earlier structural weaknesses of the domestic banks in these countries as it is about the behavior of foreign subsidiaries. Again, I would refer you to the paper by Governor Ferguson on this issue. His central point is that "whether foreign banks are a source of stability or fragility depends very much on the market, banking and supervisory environments that they find in the host country. There are conditions that must accompany or, better still, precede a country's decision to participate in today's global banking market. If the participation of foreign banking competition, either directly or through inter-bank lending,

comes with improvements in the underlying bank credit underwriting culture, the capability of bank supervisors, and the degree of transparency, then the benefits of foreign bank participation will eventually emerge." No doubt foreign banks can bring to a country capital, improved technical and management skills, and better standards in the conduct of banking business. But whether in the end they will add to the stability of the financial system will depend on the quality of the legal and regulatory structure in both the financial and nonfinancial sectors of the host country.

The analysis of the stability of alternative forms of foreign lending to the three countries considered in the paper, while providing some support for foreign subsidiaries, should be interpreted with a bit of caution. How stable lending from foreign subsidiaries will be cannot be determined simply by looking at foreign bank flows, without empirical testing. Recall that in 1986 six of the ten large U.S. money center banks had cross-border exposure to Brazil equal to more than 30 percent of their capital (Musumeci and Sinkey 1990). It took some time for many of them to return to Latin America after the crisis, even with an earlier brick and mortar presence.

These comments are meant simply to inject a bit of skepticism into some of Peek and Rosengren's possibly excessive optimism on the stabilizing benefits of foreign bank entry. But surely it is difficult to disagree with the general thrust of their argument. Europe has a good example to add to their three Latin American stories, Poland. In mid 1999, of the 80 banks in Poland, 34 were fully or majority-owned by foreigners, and 52 percent of bank capital was in foreign banks.[3] According to Storf (2000), the Polish government early on recognized that only with foreign bank participation could bank privatization and an efficient banking system be achieved. However, it came with a cost. The entry fee required was foreign bank takeover of a weak Polish bank or the purchase of Polish government capital market securities. And as implied by Governor Ferguson's remarks on the need for a sound financial infrastructure, the success in Poland was in part due to its Law on Financial Restructuring of Enterprises and Banks, which aided in the resolution of the bad loan problem. We also have seen, as shown in the study by Claessens and his colleagues (1998) at the World Bank, that the profitability of banks in Poland has declined significantly as a result of the increased competition.[4]

The benefits from foreign bank entry into Poland have been the same as those Peek and Rosengren suggest could be forthcoming in Latin America: an increase in the professional quality of local staff through

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[3] The OECD (2000) puts the figure at around 60 percent, making Poland one of the most internationalized banking systems in the world.

[4] By OECD (2000) statistics, the gross profits/income ratio for Polish banks was cut in half between 1995 and 1998. Storf (2000) finds that "fierce battles for market share" have reduced margins in Poland to 0.2 to 1.5 percent, down from 3 to 4 percent two years ago.

training, improved bank management, new products, plentiful capital, and a big increase in competition (Storf 2000). A similar story can be told for Hungary, where in 1999 of the 43 banks in operation, 30 were fully or majority-owned by foreign investors, accounting for 61 percent of the capital in the banking system. How much is too much remains unanswered.

Is foreign bank entry a good thing? Yes, but only if the "market, banking and supervisory environment" in the host country is a source of stability. Claessens' (1996) study of 25 transition economies found the "new entry approach" to be more successful than the "rehabilitation approach," particularly when the institutional structure is weak. Those who have looked carefully at the success in restructuring the banking systems in Poland and Hungary attribute it to "legal certainty, political stability, rapid implementation of reforms, successful structural reforms, and a smoothly functioning infrastructure"(Storf 2000). To understand the potential long-run contribution of foreign bank entry in Latin America, Peek and Rosengren might want to ask whether these fundamental structural elements have been firmly established. An examination of the stability of onshore lending by foreign subsidiaries and cross-border lending is helpful, but only part of the story.

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