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Financial Liberalization and Foreign Bank Entry in Emerging and Developing Economies: What Does the Literature Tell Us?

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An important feature of international financial liberalization in several emerging market and developing economies (EMDEs) over the last two decades has been the rising foreign bank participation in their domestic banking systems. While the term financial liberalization has been widely used in literature, it is often not carefully defined. What is the relationship between foreign bank entry and financial liberalization? This paper lays out a simple framework to understand the different components of financial liberalization, its relationship with domestic deregulation as well as foreign bank entry and also surveys the trends and implications of foreign bank entry in EMDEs.

Keywords: Foreign bank entry; financial liberalization; financial development.

JEL Classifications: F21, G00, G21, O16

1. Introduction

Over the last two decades, several emerging market and developing economies (EMDEs)[1] have embraced domestic as well as international financial liberalization. While there is considerable heterogeneity in the details of the policy mixtures adopted by individual countries, the broad contours have remained constant across the board, with most countries opening up their economies to cross-border flows of private capital and their financial systems to both domestic and foreign entrants. Openness to capital flows has broadly involved a combination of capital account openness to different degrees as well as the internationalization of the financial sector featuring foreign bank entry.

From a theoretical standpoint, the relationship between financial liberalization and economic growth is ambiguous at best. Beginning with the influential work of McKinnon (1973) and Shaw (1973), several studies have argued that a movement away from "financial repressive" policies by eliminating credit controls and deregulating interest rates, as well as allowing greater competition in the banking sector,

[1] We adopt the classification followed by Claessens and Van Horen (2011) of EMDEs.

could bring positive growth benefits. Combined with liberalization of international capital flows, financial liberalization could result in greater economic growth through efficient allocation of capital across borders, transfer of best practices in technological know-how and management as well as increased production specialization due to better risk management practices (see Williamson and Mahar, 1998; Bekaert *et al.*, 2005 for reviews).

However, another set of studies based on the "theory of the second best" has argued that the removal of one distortion need not necessarily be welfare-enhancing when other market distortions are present. As Kose *et al.* (2009) and Galindo *et al.* (2002) note, international capital flows going into certain protective industries could have "perverse effects" by exploiting the benefits of protection in domestic markets, resulting in welfare losses and sub-optimal growth (Brecher and Diaz-Alejandro, 1977). Similarly, a growing literature building on the work by Stiglitz (2004) has also noted that information asymmetries stemming from a lack of transparency in financial institutions could lead to inefficient allocation of capital flows, generating maturity mismatches and resulting in costly crises (also see Stiglitz and Weiss, 1981). Further, as the comprehensive survey in Kose *et al.* (2009) reveals, the cross-country empirical literature appears to be fairly inconclusive in establishing that financial openness on the whole has had a discernible positive impact on growth (Eichengreen, 2001; Contessi and Weinberger, 2009; Kose *et al.*, 2009).

While the growth-effects of financial openness remain heavily contested, what can be said with certainty is that if it does not take place in a well-sequenced and timed manner, it could lead to episodes of severe financial instability and distress (Bird and Rajan, 2001; Cobham, 2002; Prasad and Rajan, 2008). To be sure, while there is no universal model as to what the appropriate sequencing of financial openness must be, there seems to be a consensus that a combination of internal financial deregulation and domestic macroeconomic stabilisation are *necessary but insufficient* conditions for countries to benefit from full-fledged external financial liberalization. The sufficiency conditions however would be satisfied only when there are complementary prudential and institutional regulations that accompany the process of financial openness (Eichengreen, 2001; Lee, 2002; Kaminsky and Schmukler, 2008).

In a related strand of work, Kose *et al.* (2009) propose an alternative unifying framework to examine the impacts of international financial liberalization on growth and emphasize that the indirect benefits such as developing domestic financial markets and improving corporate and public governance may be more important than the direct benefits through the traditional financing channels that has been the focus so far. This literature also emphasizes that for countries to reap even such indirect benefits, a certain "threshold" of domestic financial and institutional development is required, without which the risk of such financial liberalization may be large (Kose *et al.*, 2011).[2]

[2] Also see Aizenmann *et al.* (2015) for a discussion on the possible nonlinear relationship between financial development and output growth.

While the literature exploring the relationship between financial liberalization and economic growth is growing, much of the ambiguity surrounding this relationship appears to stem from a failure to carefully define the term "financial liberalization". Considering that the term has both a domestic as well as an international dimension, it is important to define the term carefully before drawing inferences about its implications. Further, what is the relationship between financial liberalization and foreign bank entry? Section 2 of the paper begins by providing a schematic framework to understand the different dimensions of financial liberalization and also relates the discussion to international banking liberalization and foreign bank entry. It also dwells on the literature concerning sequencing of domestic *vis-à-vis* international financial liberalization. Section 3 examines the policy issues and concerns arising from rising foreign bank entry in EMDEs. Section 4 concludes with a discussion on the importance of organizational modes of entry of foreign banks from a policy standpoint and points out directions for future research.

2. Understanding International Financial Liberalization

The term financial liberalization, while widely used, is often not carefully defined. Figure 1 schematically represents the different types and degrees of financial liberalization. Broadly, one can represent the types of financial liberalization by first making a distinction between domestic and international financial liberalization. *Domestic financial liberalization* involves among other things, the relaxation of domestic credit controls, interest rate controls, and encouraging domestic–private bank competition (i.e., the opposite of financial repression) (as well as easing restrictions on domestic balance sheet holdings).[3] *International financial liberalization*, on the other hand, is generally loosely defined to encompass both capital account liberalization as well as internationalization of financial services. This can in turn be bank-based or non-bank-based, with the former specifically involving the banks in cross-border flows of equity or commercial lending and the latter referring to other equity and bond flows excluding banks.

2.1. *Capital account liberalization versus internationalization of banking sector*

However, many observers of international financial liberalization fail to make a distinction between capital account liberalization *per se*, on the one hand, and banking sector internationalization on the other hand. While capital account liberalization involves the process of removal of all forms of capital controls (implying complete inward and outward capital mobility) and possibly also restrictions on the convertibility of a country's currency, banking internationalization is broadly defined as the

[3] For more on domestic financial liberalization, see Ang (2009), Williamson and Mahar (1998), Ito (2008) and McKinnon (1991).

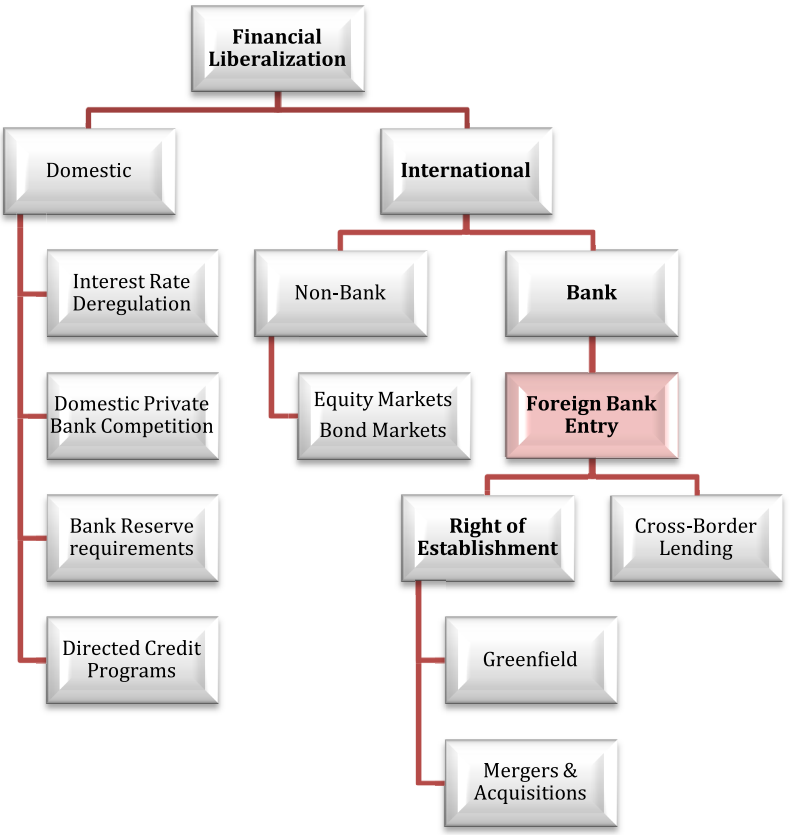

Figure 1. Financial liberalization — A schematic representation.
Source: Author.

elimination of barriers to entry and discriminatory treatment of foreign competition as well as cross-border provision of banking services (Bird and Rajan, 2000; Rajan and Noy, 2009).

Focusing specifically on international banking liberalization, a country can open up its banking sector to foreign competition in two fundamental ways. One is to allow direct investments in the banking sector (banking foreign direct investment (FDI) or foreign bank entry through right of establishment), while the other is to allow for cross-border banking activities (that involves lending and borrowing activities involving foreign banks). While the latter essentially involves partial capital account liberalization, the former could be in the form of Greenfield investments or mergers and acquisitions (M&A).[4]

Tangentially, it is also useful to place this process of liberalization under different modes of financial services trade as outlined by the General Agreement on Trade in Services (GATS). There are four modes of supply through which trade in services

[4]Greenfield or M&As can take different organizational forms, i.e., branch or a subsidiary or a representative office.

occur in general. We explain the case of financial services trade by considering the following hypothetical example (with India as the host country). *Mode* 1 (cross-border supply) refers to transactions that involve cross-border supply of the service but not the service supplier, i.e., for example, the granting of a loan by a New York-based bank to an Indian consumer located in India. *Mode* 2 (consumption abroad) involves consumption of a service abroad, i.e., opening of a bank account by an Indian resident while travelling in the United States. *Mode* 3 (commercial presence) entails the commercial presence of a supplier of one country in the jurisdiction of another country, i.e., when a United States bank (or any other financial institution) establishes an agency, branch or a subsidiary in India to supply financial services in India (this is the mode that is applicable to our discussion of foreign bank entry in this paper). *Mode* 4 (temporary movement of natural persons) covers the supply of services through the temporary presence of natural persons, i.e., bank officials sent from the parent bank in the United States to the bank's branch or subsidiary in India.

Keeping this in mind, let us examine the nexus between capital account liberalization and bank internationalization borrowing the framework of Kono and Schuknecht (1999) as shown in Table 1 (also see Bird and Rajan, 2000). Cell I on the uppermost left-hand corner refers to the case of financial autarky, i.e., neither financial services trade nor an open capital account. The diametrically opposite case can be found in Cell IV on the bottom right-hand side which denotes the case of "complete" international financial liberalization, i.e., liberal capital account as well as bank internationalization to include provision of cross-border banking services as well as foreign bank presence through right of establishment. The remaining two cells may be broadly classified as "partial international financial liberalization". Specifically, Cell II involves the case of partial bank internationalization with capital restrictions (i.e. liberalizing Mode 3 commitments to allow foreign bank entry through right of establishment but not commit to Mode 1 which involves provision of services such as

Table 1. Domestic versus international capital flows and bank internationalization.

	Loan provided by domestic supplier	Loan provided by foreign supplier*
Loan involves domestic capital only	Cell I: Neither financial services trade nor international capital flows.	Cell II: Financial services trade plus inward direct investment.
Loan involves international capital only	Cell III: International capital flows only.	Cell IV: Financial services trade plus inward direct investment and international capital flows related to the supply of the loan.

Note: Refers to the case of a loan provided by a bank that has established a domestic presence in the host country.
Source: Adapted from Kono and Schuknecht (1999).

cross-border bank lending); while Cell III pertains to the case of capital account deregulation though with restrictions on all forms of banking internationalization.

The point to be emphasized here is that while liberalization of FDI in the banking sector would be required to achieve liberalization of financial services trade through commercial presence (Mode 3), it is also possible for countries to liberalize Mode 3 provisions by permitting foreign banks to "set up shops" but restrict cross-border capital movements by limiting their commitments in Mode 1.[5] Thus the two concepts are inter-related but not equivalent and have very different policy implications, which is why making the distinction is imperative.

One of the dimensions of international financial liberalization is foreign bank entry associated with the right of establishment, which is more narrowly measured in terms of the number of foreign owned banks (with majority ownership stake) or their share of banking assets in the host country but not necessarily their share of loans that could be supplied cross-border.[6] Before we proceed to examine the trends and some implications of foreign bank entry, we focus on the issue of sequencing of financial liberalization and domestic deregulation and what the literature says below.

2.2. *Foreign bank entry and domestic deregulation*

To what extent are the risks of removing controls on foreign bank entry different from removing controls on domestic financial institutions? The discussion here relates to one of *sequencing* of internal financial deregulation and external financial liberalization. The approach taken in the literature has been to place both these on a continuum and draw lessons from the various divergent experiences of countries in choosing their individual ways of undertaking both domestic deregulation and external financial liberalization, more specifically capital account liberalization. While both these terms are associated but not necessarily equivalent, most papers have capital account liberalization as the end goal in mind when they are discussing the sequencing of internal and external reforms. We outline below the literature that tries to understand how countries have fared trying to achieve capital account liberalization without paying adequate attention to domestic deregulation.

It is interesting to note that the literature on sequencing has evolved since the 1970s and has undergone multiple revisions. The revisions were largely a result of the learning-by-doing process where several countries tried many different policy prescriptions and failed. With each failure, the literature was revised in retrospect and the debate still continues as to what is the best way to deal with financial liberalization.

[5] That said, in reality the various elements of international financial liberalization could be closely intertwined though the assumption of total separability is useful conceptually.

[6] There is a strand of literature that examines cross-border bank lending that pertains to direct lending from foreign banks outside a country to firms or consumers in a host country. The discussion in this paper is confined to the implications of foreign banks with the right of establishment. For more literature on cross-border foreign bank lending and Mode 1, see McGuire and Tarashev (2008), Herrmann and Mihaljek (2010), Cetorelli and Goldberg (2009) and Kamil and Rai (2010).

However, it is worth reiterating that one common theme that runs across this sequencing literature is that there is no universal model or a "cook-book" recipe as to what the sequencing of reforms must be (Eichengreen, 2001; Lee, 2002; Kaminsky and Schmukler, 2008). All the same, a consensus appears to have been reached that a combination of internal financial deregulation, domestic macroeconomic stabilization as well as trade liberalization is a *necessary but insufficient* condition to benefit from full-fledged external financial liberalization; the sufficiency condition is provided by complementary prudential and institutional regulations.

It is also important to note that while a broad set of tenets seem to have emerged from the literature as to how countries should proceed with financial liberalization, there is no apparent global consensus *a priori* as to whether financial liberalization as such is desirable in the first place. However a debate of that kind assumes a normative tone and hence our focus is restricted to available empirical evidence. It is also useful to keep in mind that direct comparisons of the effects of foreign banks particularly are harder to disentangle because the broader set of reforms undertaken by many countries touch upon other aspects of international financial liberalization such as capital account deregulation.

Thus, as noted, the available empirical evidence gives us ideas about different country experiences in terms of what they underwent by trying to adopt capital account liberalization without paying sufficient attention to domestic deregulation. Tracing the evolution of this sequencing literature, we can broadly identify four sets of variables that have been emphasised at different points in time based on country experiences.

The early ideas emerged out of the failed experiments with financial liberalization policies adopted by the "Southern Cone" countries to include Argentina, Chile and Uruguay in the late 1970s. This emphasized the importance of achieving domestic macroeconomic stabilization, domestic financial deregulation move away from "financial repression", as well as trade liberalization before proceeding with capital account opening (McKinnon, 1991; Edwards, 1990). However, as rightly emphasized by McKinnon (1991), the Southern Cone failure was more a problem of sequencing of reforms as opposed to a problem with financial liberalization policies as such. McKinnon (1991) emphasised that the first step of this sequence was to get the fiscal house in order by balancing the government budgets; the second was to allow for domestic interest rate deregulation, i.e., let go off financial repression that would in turn free up credit allocation; and a subsequent move to privatize the banks should be undertaken. McKinnon (1991) proposed that the liberalization the exchange rate for current account transactions along with liberalization of international trade must precede that of international capital flows. Thus, the sequencing literature already had a laundry list of conditions to be undertaken at the domestic level before going for full-fledged external financial liberalization.

However one notable piece that was missing from this discussion was that of prudential regulations, which became very important in the light of EME crises of the 1990s. Studies emphasized the need for adequate prudential regulations and

institutional reforms to safeguard economies from the instabilities arising from pursuing capital account liberalization. The focus was thus on an "integrated" approach, treating capital account liberalization as part of a more comprehensive program of economic reform that includes appropriate macroeconomic and exchange rate policies as well as policies to strengthen the financial system (Johnston *et al.*, 1997; Kawai and Takagi, 2010).

Investigating the relationship between the domestic financial liberalization and capital account liberalization, Johnston (1998) suggests that before opening capital accounts, the financial intermediaries need to be strengthened in order to guarantee the efficient use of capital inflows. Countries with weak financial systems may need time to develop financial institutions and markets, especially the banking sector, before liberalizing their capital account. Thus the emphasis was not just on trade liberalization or macroeconomic stability or domestic financial deregulation but also on establishing an effective system of prudential supervision before liberalizing the capital account. Along similar lines, with an emphasis on prudential supervision, Mishkin (2001), argues that in order for international financial liberalization to generate beneficial outcomes and to avoid financial crises, institutional and governance prerequisites such as adequate prudential supervision, accounting and disclosure standards, reduction of the role of state-owned financial institutions, etc. are important policy measures that need to be in place before opening up a country's capital account.

In a useful survey of the path followed by 28 different developed and emerging economies since 1973 in terms of the order of financial liberalization, Kaminsky and Schmukler (2008) note that most industrial countries have liberalized their stock markets first while most developing countries had a tendency to open their banking sector first. While all Group of Seven (G7) countries liberalized their stock markets first, European countries followed a mixed strategy. A related result that comes from their study is that the liberalization of domestic financial markets happened before the opening of capital accounts in developed countries but this order of liberalization was very different in developing countries. While Latin American countries generally liberalized their domestic financial sectors first, East Asian countries implemented a mixed strategy. They also find that economic crashes were more severe in developing economies if the capital account is liberalized first, conforming to the broader notion of having pre-requisites before opening up capital accounts. So, while the growth-effects of financial liberalization remained heavily contested on the one hand, what can be said with certainty was that if international financial liberalization did not take place in a well-sequenced and timed manner, it could lead to episodes of severe financial instability and distress (Bird and Rajan, 2001; Cobham, 2002; Prasad and Rajan, 2008).

Echoing this theme, Eichengreen (2001) has stressed that optimal sequencing strategies of capital account liberalization will vary from country to country depending on their levels of economic and financial development as well as their institutional structures. However, as the paper notes, in general a country with a fully liberalized domestic financial system with "adequate safeguards" could proceed towards full

capital account liberalization. This is mostly applicable to the industrial countries as opposed to the EMDEs. At the same time though, maintaining tight restrictions all forms of international financial flows till complete domestic financial deregulation may not be appropriate as both of them have to develop in tandem. While FDI sometimes raises concerns about foreign ownership and control, such investments can also potentially bring considerable benefits, including technology transfers and more efficient business practices. Moreover, considering that they are less prone to sudden reversals compared to other forms of capital like bank loans and debt financing, they do not generate the same acute problems of financial crises as do sharp reversals of debt flows. Thus, liberalizing FDI could be an attractive component of a broader program of liberalization.[7]

Claessens (2006) also emphasizes that it is important to consider the interactions between three components of financial liberalization, viz. *capital account liberalization*, *financial services liberalization*, and *domestic deregulation*. Domestic financial deregulation allows market forces to work by eliminating controls on lending and deposit rates and on credit allocation, by reducing the dividing line between different types of financial service firms (such as banks), and more generally by reducing the role of the state in the domestic financial system. Capital account liberalization involves a process of removal of capital controls and restrictions on the convertibility of the currency. Internationalization of financial services eliminates discrimination in treatment between foreign and domestic financial services providers and removes barriers to the cross-border provision of financial services. The point is that these three components, while conceptually distinct, are interrelated in many ways.

While liberalizing along all three dimensions is considered "mutually reinforcing", there are issues of concern with the three forms of liberalization. Financial services liberalization can require some degree of capital account liberalization as foreign banks need access to international financial markets to operate effectively. Domestic deregulation and capital account liberalization can involve both the removal of lending restrictions, which needs to be done consistently across the two forms. Similarly, internationalization of financial services and domestic deregulation though related, do not necessarily imply each other. A country might deregulate its financial system but still keep its financial markets closed to foreign competition (like Japan, which has a deregulated domestic financial system but relatively closed to foreign providers). Or a country might regulate its domestic markets but freely allow foreign firms to open local establishments and compete with domestic providers (Claessens and Glaessner, 1998; Claessens, 2006). Despite the recognition of these various inter-connections, the

[7] However, this conventional wisdom is applicable more for FDI that takes the form of Greenfield investments. The other form of FDI that has been growing in importance, especially to EMDEs, has been M&A. Given that the difference between what gets classified as FDI and foreign portfolio investment (FPI) is the 10% ownership threshold, a cross-border acquisition (M&A) of 10.1% is regarded as FDI. In such a scenario, it is not very clear if the stability implications of such FDI in the form of M&A are very different from FPI which are regarded as "hot money". For more see Hattari and Rajan (2011).

literature still largely appears to be unclear about how countries should move forward with regard to overall sequencing of reforms (Bayraktar and Yang, 2004).

Notwithstanding the lack of consensus on the sequencing of reforms, the series of EMDE crises in the 1990s covering the entire spectrum of countries from Latin America to Asia provided a major impetus for these economies to open up their domestic markets to foreign banks (Crystal *et al.*, 2001; Tschoegl, 2005; Gopalan and Rajan, 2010). Despite the variations in the degree and scope of involvement of foreign banks between regions and countries since then, foreign bank presence has grown significantly across the board in the EMDEs.[8] How important and different are these banks in these economies? Section 3 will provide an overview of the trends and implications of foreign bank entry in EMDEs.

3. Foreign Bank Entry in EMDEs: Overview of Trends and Implications

3.1. *Trends*

As noted earlier, many EMDEs — especially in Latin America and East Asia — started allowing foreign banks to enter after they underwent a financial crisis, primarily to use them as a means of recapitalizing their beleaguered domestic banking system. Measured in terms of the share of foreign banks (in terms of numbers) relative to the total number of banks across EMDEs spanning all regions in the world, this share has increased from 21% in 1995 to 35% in 2009. The same is largely true of the EMDEs within every region, though there are notable variations.

On average, between 1995 and 2009, foreign banks constitute more than half the share of the total banks in sub-Saharan Africa and Europe and Central Asia while it is slightly under 50% for Latin America and Caribbean. Over the years, sub-Saharan Africa has seen this share grow from only from about 41% in 1995 to 57% in 2009, Europe and Central Asia has seen a dramatic increase from 13% to 55% in the corresponding period. Latin American and Caribbean closely tracks Europe and Central Asia with the region, having witnessed a rise in share of foreign banks from about 27% in 1995 to 47% in 2009. The other regions have also experienced a rise in foreign bank representation, though they are much more modest. In the Middle East and Northern Africa, the share of foreign banks relative to the total number of banks rose from 14% to 30% between 1995 and 2009. The EMDEs in Asia have been relatively slow compared to other regions in permitting foreign banks in, though the shares are growing. In the East Asia and Pacific region particularly, the percentage of foreign banks rose from 13% to nearly 26% during the same period, while South Asia saw a marginal rise from close to 9% to close to 13% between 1995 and 2009.

The problem with using number of banks is that they do not capture the extent of foreign bank penetration into the domestic banking system as the nature of their

[8] We adopt the classification followed by Claessens and Van Horen (2011) of EMDEs.

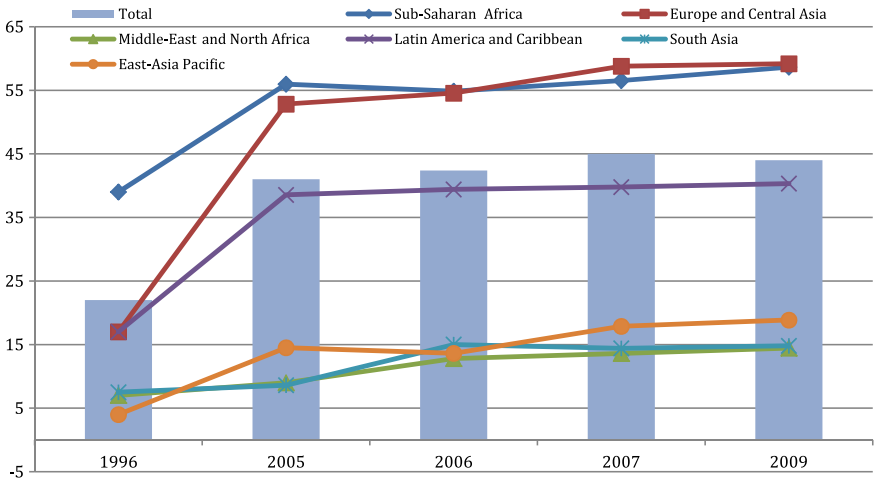

Figure 2. Share of foreign bank assets in total banking assets across EMDEs.
Note: This figure shows the average share of assets held by foreign banks (expressed as percentage of total assets) in each region at each point in time. A bank is considered foreign when it owns atleast 50% of shares.
Source: Author based on data from Claessens *et al.* (2008) and Claessens and Van Horen (2011).

operations could depend on the mode of entry. For instance, as Gopalan and Rajan (2010) note, at a disaggregated level, the number of foreign banks in some countries in Asia actually went down between 1997 and 2008 despite the various regulations designed to ease the entry norms for foreign banks, though overall the region saw a rise in the number of foreign banks. This seemingly counter-intuitive result was largely driven by major consolidations and domestic restructurings among local banks. Therefore, a preferable yardstick of the extent of foreign bank presence in a country is to look at the percentage share of their assets in the domestic banking system. The share of foreign bank assets in the total banking system across EMDEs has doubled from 22% to 44% between 1995 and 2009 (Fig. 2).

The data also suggest that the assets share closely tracks foreign bank presence in terms of their numbers.[9] As Fig. 2 reveals, on average, the same three regions — sub-Saharan Africa, Europe and Central Asia and Latin America and Caribbean dominate in terms of the percentage shares of assets owned by foreign banks. While sub-Saharan Africa saw its foreign bank assets rise from an average of 39% in 1996 to close to 60% in 2009, the corresponding shares in Europe and Central Asia rose from 17% to 60%. Latin America also witnessed a remarkable change, with shares growing from 17% to 41% on average between 1996 and 2009. As noted earlier, compared to the other

[9] As Claessens and Van Horen (2011) note, countries with more number of foreign banks tend to have higher representation in terms of asset shares too because foreign banks play a much larger role in terms of financial intermediation in countries where they are more in numbers. On the other hand, they tend to be niche players in countries where they are less in numbers.

Table 2. Descriptive statistics for the share of foreign bank assets across regions, 2009.

Region	Minimum		Median	Maximum		Coefficient of variation
	%	Country	%	%	Country	
Sub-Saharan Africa	0	Ethiopia	61	100	Burkino Faso	0.6
Europe and Central Asia	3	Azerbaijan	70	99	Estonia	0.6
Middle-East and North Africa	0	Iran, Yemen, Oman and Libya	14	36	Lebanon	1
Latin America and Caribbean	0	Cuba and Haiti	34	100	Argentina	0.8
South Asia	0	Sri Lanka	5	53	Pakistan	1.5
East-Asia and Pacific	1	China	18	54	Cambodia	1

Note: This table shows the minimum, median, maximum and coefficient of variation (standard deviation divided by the mean) of the share of assets held by foreign banks in each region. The countries with the minimum and maximum share in each region are also reported.
Source: Computed based on Claessens *et al.* (2008), Claessens and Van Horen (2011) and Cull and Martinez Peria (2010).

regions, on a relative basis, the degree of foreign bank presence in East Asia and Pacific, South Asia and the Middle East and Northern Africa has been smaller though the shares are rising in importance. While the average share of foreign bank assets doubled between 1996 and 2009 in Middle East and Northern Africa from 7% to 14%, East Asia experienced a tripling from 4% to 19% in the same period and South Asia almost doubled from about 8% in 1996 to at 15% in 2009.

An obvious point that emerges from the trends discussed above is the notable degree of variability in foreign bank presence (both in terms of numbers and asset shares) among regions which can also be seen from Table 2 and Fig. 3 where we identify the maximum and minimum share of assets held by foreign banks in each region along with the coefficient of variation of assets as of 2009.[10]

Two key points are worth noting from Table 2. First, we find that there is atleast one country within every region that either has no foreign bank participation or extremely low shares. While Ethiopia, Iran, Yemen, Oman, Libya, Cuba, Haiti, Sri Lanka have no foreign bank presence, China and Azerbaijan have extremely low shares of foreign bank assets in their countries. Second, we see large variations between the median shares and the maximum shares reported in each region. South Asia is an appropriate

[10] We follow Cull and Martinez Peria (2010) who perform a similar exercise using data for 2005 and reports only coefficient of variations for one year. But we track the changes over time as we find important changes within regions over time in terms of foreign bank presence. The variations we observe within countries in specific regions like South Asia or East Asia and Pacific show that not all countries in the region have allowed foreign banks to enter their economy in a uniform fashion. The degree of foreign bank participation appears more uniform through other regions such as Europe and Central Asia, Latin America and Caribbean and sub-Saharan Africa.

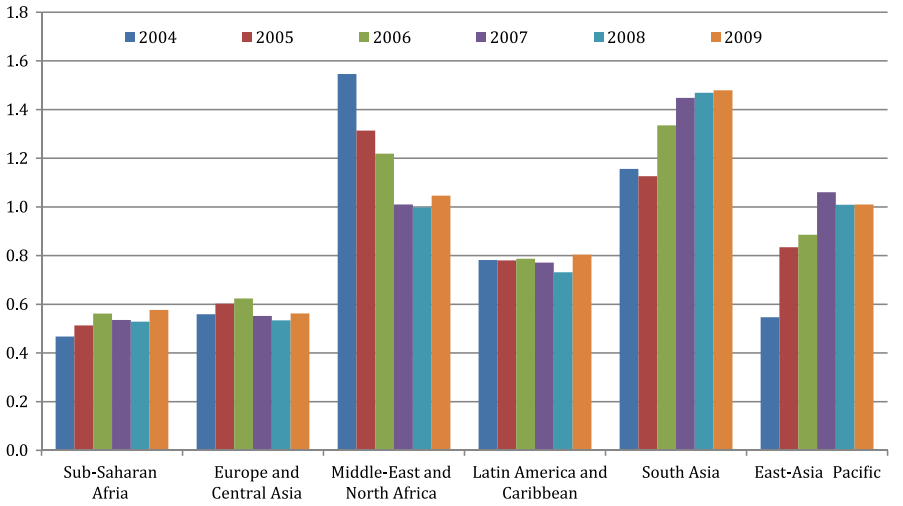

Figure 3. Coefficient of variation of foreign bank assets across regions (2004–2009).
Source: Author based on data from Claessens *et al.* (2008) and Claessens and Van Horen (2011).

example as we find that median share of assets is 5% though the maximum share of assets held by foreign banks is 53% in Pakistan. Similar trends can be observed in Latin America, Middle East and East Asia, while sub-Saharan Africa and Europe are far more consistent. This is also reflected in the coefficient of variations of assets shares in 2009 where with South Asia, East Asia and Middle East have exhibited the most variance in terms of foreign bank ownerships, followed by relatively less variability in other regions.

We also compute the coefficient of variations for foreign bank assets across regions over 2004–2009 (for which consistent data was available) in order to check if significant variations over the years can be identified for each region. The set of EMDEs hailing from East Asia, South Asia and Middle East have exhibited considerable volatility over the five years. This pattern adds one more layer of evidence to suggest that the patterns of allowing foreign banks to come in to their economies have been much more heterogeneous than the other countries.

The data above makes apparent the heterogeneous pattern of foreign bank participation in EMDEs across different regions. However, the trends also indicate that the shares of foreign banks in terms of their numbers as well as their assets have been growing in significance. This raises some important analytical and policy issues concerning the impact of foreign bank entry in host markets. What have been the effects of EMDEs opening up their domestic banking sector to foreign competition? Before we explore their multi-dimensional implications, it is important to understand the drivers of such foreign banks to various EMDEs. What does the literature find as the prime motivating factor for foreign banks to enter EMDEs?

3.2. *Determinants of foreign bank entry in EMDEs*

While it is true that many EMDEs — especially in Latin America and East Asia — started allowing foreign banks to enter their economies after they underwent a financial crisis, what motivates a bank to venture overseas in the first instance? The decision pertaining to why foreign banks enter EMDEs goes well beyond the notion of seeking profits. There is a sizeable literature that discusses its motives and connects the decisions of foreign banks to go abroad to the theory of multinational enterprises (MNEs) in general.

The theoretical literature concerning the question of what influences banks' decisions to go abroad can be treated as a subset of the theory of MNEs. The two leading paradigms borrowed from the theory of MNEs — the internalization theory and the eclectic paradigm — have been applied to the banking industry to understand the motives for banks to go abroad (Buckley and Casson, 1976; Dunning, 1980). While the debate in the literature about which paradigm is more suitable to the foreign bank literature is unsettled, both the frameworks place considerable emphasis on the theme of internalization (Curry *et al.*, 2003; Williams, 1997). The central idea behind the theory is that the source country firms possess some intangible firm-specific advantages in the domestic market that can be used effectively in the foreign market at a low marginal cost owing to presence of negative externalities in the home market. This has been couched as the broader rationale for banks to expand abroad (for useful overviews, see Buckley and Casson, 2009; Rugman and Verbeke, 2008; Rugman, 2010).

The empirical literature complements the theoretical literature in the sense that the testable hypotheses have largely flowed out of the theories of multinational banking. The studies suggest that the reasons why banks go abroad may broadly be explained by a set of microeconomic, macroeconomic and institutional factors. Specifically, the micro set of determinants — borrowing insights from the internalisation theory — primarily relate to the desire of the banks to follow their clientele abroad (defensive expansion)[11] and the motives to achieve geographical diversification (for instance Soussa, 2004; Guillén and Tschoegl, 1999). The institutional determinants, on the other hand, mainly relate to the foreign banks exploiting the regulatory arbitrage between the host and home countries as well as taking advantage of the reduction in information costs of doing business in foreign markets.[12]

The macroeconomic determinants relate to a set of both pull factors on the host country side as well as push factors from the home country side. More specifically, while the profit and growth opportunities based on risk perceptions constitute the pull factors from the host country's perspective, other specific macroeconomic and

[11] An illustrative set of studies that find evidence of defensive expansion as the motive for banks to go abroad include Goldberg and Saunders (1980, 1981a,b), Grosse and Goldberg (1991), Goldberg and Johnson (1990) and Brealey and Kaplanis (1996).

[12] A selected set of papers that focus on institutional determinants of foreign bank entry include Barth *et al.* (2001, 2013), Focarelli and Pozzolo (2001) and Galindo *et al.* (2003).

financial conditions including market saturation in the home country act as the push factors in affecting a bank's decision to go abroad.[13]

While a combination of factors appears to be at work in influencing the decision of a bank to go abroad,[14] it is also important to understand the effects of such a decision from a standpoint of the host economy and how the organizational mode of entry is tied to the various implications foreign banks generate in the economies they enter. We provide a framework in the next section to examine the impact of greater banking sector openness to foreign competition in EMDEs and conclude with a discussion on the implications of the organizational choice of foreign bank entry.

3.3. *Impact of foreign bank entry: What does the literature say?*

Figure 4 provides a snapshot of the literature on foreign bank entry and the associated implications when they enter a host economy. As illustrated by the figure, foreign banks appear to affect the host country in numerous ways, which involves a combination of costs and benefits.

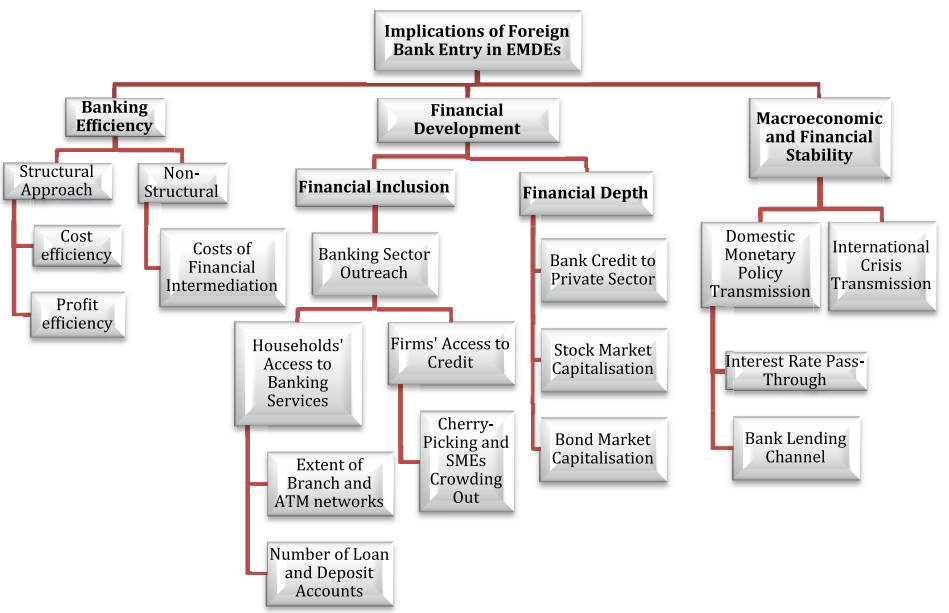

Figure 4. Multi-dimensional implications of foreign bank entry.
Source: Author.

[13] Some papers that fall under this strand of literature are Brealey and Kaplanis (1996), Yamori (1998), Buch (2000), Buch and Lipponer (2004), Claessens *et al.* (2000) and Soussa (2004).

[14] While the literature introduces a variety of motives to enter another economy, it is largely silent as to which motives are more important than the other. Such a ranking could be an useful direction for future research. See Rajan and Gopalan (2014) for a detailed survey of literature on the determinants of foreign bank entry in EMDEs.

Several studies document evidence of greater efficiency gains to the domestic banking system in the host countries, particularly in the context of EMDEs. A voluminous body of evidence points out how foreign banks generate efficiency gains by facilitating a reduction in cost structures, improvements in operational efficiency, introduction and application of new technologies and banking products, marketing skills and management and corporate governance structures. In relation to this, foreign banks could enhance the quality of human capital in the domestic banking system by importing high-skilled personnel to work in the local host subsidiary as well as via knowledge spillovers to local employees which may in turn benefit the customers in terms of access to new financial services.[15]

Beyond the promise of efficiency improvements, which remains the most oft-cited rationale for allowing foreign banks, the literature also broadly points to how foreign banks contribute to the development of overall financial and money markets in the host economy which eventually leads to favourable economic growth (see for instance Levine, 1996 and references cited within). Broadly, the literature points to how foreign banks through their credit creation could deepen the development of the financial sector (financial depth) as well as broaden the accessibility of financial services for households and firms (financial inclusion) — the two prime components of financial sector development. To be sure, financial (sector) development broadly can be defined as "the factors, policies, and institutions that lead to effective financial intermediation and markets, and deep and broad access to capital and financial services" (World Economic Forum, 2012, p. xiii). Thus the additional capital that they bring into the host country could not only facilitate productive resource allocation (Wu, 2011) and enhance the efficiency of the domestic banking system, but could also result in increased credit availability that facilitates overall financial development in the host country (Claessens *et al.*, 2001). As the literature points out, financial development broadly can be divided into two components — financial depth and financial inclusion.

The first aspect concerns financial depth. Foreign banks could contribute to financial sector deepening which could be reflected in either the expansion of banking credit to the private sector or enhanced liquidity in the domestic equity market or well-capitalized bond market. While, generally studies have found evidence that foreign banks contribute to reduced costs of financial intermediation that results in increased credit availability and enhanced financial development in the host country (Claessens *et al.*, 2001), there are also studies that point out that this may not necessarily be the case in EMDEs.[16] An important qualification to these results though is that there is a

[15] It is pertinent to note that studies on banking efficiency have effectively dominated the foreign bank literature and empirical studies on banking efficiency are abundant. They have been carried out for both individual and a group of countries (cross-section) spanning all levels of development (emerging, transition and advanced economies) covering different regions (Europe, Asia, Latin America and Sub Saharan Africa), using different methodologies (structural and non-structural). See Rajan and Gopalan (2014) for a detailed survey of this literature.

[16] For instance, see Rashid (2011), Claessens and Van Horen (2011), Cull and Martinez Peria (2010) and Detragiache *et al.* (2008).

need to allow for differences in economic development between countries before attributing a negative relationship between foreign banks and financial depth. In recent research, Gopalan (2015) probes this nexus between foreign bank presence and financial deepening for 57 EMDEs over 1995–2009 and finds that foreign banks tend to not only have a direct positive impact in furthering financial depth, but also that the marginal effects of foreign bank entry diminish as income levels rise. In other words, the impact of foreign bank entry tends to become smaller as the country attains a higher level of economic development.

The second aspect concerns how foreign banks broaden the accessibility of financial services for households and firms which promotes financial inclusion in the economy, pertaining to the issue of access to the formal credit market by firms and households.[17] This is also sometimes referred to as banking sector "outreach", i.e., the degree to which the banking sector is able to meet the needs of a large segment of the population. In bank-based financial systems, where banks dominate other forms of providers of financial services, the question of how foreign banks influence banking outreach assumes policy significance. There are concerns that the entry of foreign banks could be negatively associated with banking sector outreach as captured for instance by a general decline in the number of deposit and loan accounts, owing to the tendency of foreign banks to cater to a smaller segment of the population (Beck and Martinez Peria, 2009 and references cited within). However, other papers like Gopalan and Rajan (2015a) find a positive relationship between foreign bank entry and financial inclusion (using alternative indicators of financial inclusion). Examining this relationship for 57 EMDEs between 2004 and 2009, the paper finds that foreign banks have a significantly direct positive impact in furthering financial inclusion. Further, the paper also finds that the positive relationship turns negative when foreign bank entry is followed by greater banking concentration, which is an important qualification to the empirical findings. This assumes significance especially from a policy standpoint since greater foreign bank entry can possibly result in increased banking concentration, as has been the case in several Central and Eastern European or Latin American countries (World Bank, 2008).

A closely related theme in the foreign bank literature pertains to assessing the impact of credit growth on macroeconomic volatility and financial stability of the host country. The question whether foreign banks amplify or mitigate credit volatility in an economy has attracted attention in the literature especially after the global financial crisis (GFC). At the heart of this issue is the role played by foreign banks in amplifying or mitigating credit volatility in an economy. Foreign banks, on the one hand, could be a vital source of stability during periods of local stress since in theory they have the ability to raise the required funds from their head offices in their parent country. On the

[17] While provision of credit is usually channeled through the banking system in a country, it need not be the case always. In several EMDEs, even post offices play a significant role in catering to the needs of smaller households and firms by playing the core role of banks in an economy, by accepting deposits and making loans. For more discussion on the role for postal networks in expanding access to financial services, see Klapper and Singer (2013).

other hand, they could also serve as a potential transmission mechanism of external shocks which increases the instability in the host country. So the question of whether foreign banks act as a source of financial stability or a propagator of exogenous shocks into the domestic financial system (in the host countries) assumes policy significance. The related literature again specifically deals with two aspects of foreign banks' lending behavior — one, particular to episodes of global/external policy shocks and whether foreign banks act as stabilizing forces or shock transmitters (in terms of their credit supply); and two — pertaining to domestic monetary policy shocks and how they affect the domestic monetary policy transmission in a country.[18]

Much of the attention has been on studies assessing the behavior of foreign bank lending in EMDEs through local affiliates (Claessens and Van Horen, 2011) focused largely on the post GFC phase. However, some of the older literature that has been region or country specific have also examined some questions of foreign banks and credit growth (de Haas and Van Lelyveld, 2004; Detragiache and Gupta, 2006) during periods of crisis and have concluded mixed results. On the one hand, there is evidence that foreign banks may be somewhat "fickle lenders" owing to their better access to alternative business opportunities than domestic banks (Galindo *et al.*, 2005) and could potentially import shocks from their home countries, destabilising domestic banking systems (Goldberg, 2002). On the other hand, there is also a literature that documents how foreign banks could serve as a buffer in case of negative shocks, because of their diversified and comfortable liquidity sources (Detragiache and Gupta, 2006; de Haas and Van Lelyveld, 2006). It is also pertinent to recall that several foreign banks enabled faster recapitalization of domestic banking systems after a crisis, as was evident in the case of several countries in Asia and Latin America (Peek and Rosengren, 2000).

While the consensus from the literature is that foreign banks seem to promote instability through rapid cut back in their lending relative to domestic banks during GFC, there appears to be an important difference between the GFC and the previous episodes of crises that needs to be borne in mind. As Van Horen (2013) notes, the epicenter of the GFC was in the advanced economies where foreign banks are headquartered, while the previous crises originated in EMDEs which is the reason why the impact of parent funding shocks on the lending by their affiliates has come under the scanner. However, in general, many studies have found an overall positive impact when it comes to foreign banks and financial stability as they have exhibited more consistency in terms of lending during most EMDE crises. Further, foreign banks which are of the brick and mortar type appear to have been more committed than the rest that have entered new markets through mergers and acquisitions or other modes

[18] For an illustrative set of studies dealing with this dimension of foreign bank entry, see Claessens and Van Horen (2013), de Haas and Van Lelyveld (2006), Detragiache and Gupta (2006), Galindo *et al.* (2005) and Choi *et al.* (2013).

(de Haas and Van Horen, 2011) which underlines the importance of mode of entry of foreign bank entry to financial stability.

While the implications in terms of crisis transmission have been the subject of focus in the literature, how do foreign banks affect domestic monetary policy transmission? An important channel of relevance to EMDEs is the interest rate transmission as several EMDEs have moved towards flexible exchange rate regimes which have placed interest rates to be an important instrument for macroeconomic management. In recent research, Gopalan and Rajan (2015b) estimate the impact of foreign bank entry on interest rate pass-through for a 57 EMDEs over 1995–2009. They find that there are strong threshold effects in that foreign bank entry tends to enhance interest-rate pass-through only in countries with greater degree of foreign bank presence compared to those with limited entry. Notably, their results also suggest that the extent of interest rate transmission weakens when controlling for banking concentration, reiterating the need to pay attention to the resulting market structure after introduction of banking competition.

4. Conclusion

An important feature of international financial liberalization in several EMDEs over the last two decades has been the rising foreign bank participation in their domestic banking systems. As the discussion in the paper pointed out, allowing foreign banks into a host economy could generate a variety of benefits, including enhanced domestic banking efficiency, greater financial sector development and even an element of lending stability during times of crisis owing to its deep pockets. However, foreign banks could also entail significant costs to an economy especially if they increase the vulnerability of the host economy by transmitting exogenous shocks leading to domestic credit volatility. Alternatively, foreign banks could also "cherry-pick" the creditworthy borrowers in an economy, leaving the riskier pool of borrowers ("lemons") to the domestic banks which may result in a net reduction in aggregate credit supply in the economy.

While the concerned literature is growing, an important limitation of the existing literature appears to stem from a failure to sufficiently differentiate between different organizational forms of foreign bank entry, which matters a lot from a policy standpoint of the host economies. The organizational form of foreign bank operations could affect the competitive structure of the local banking systems by impacting the profitability and market share of domestic banks which in turn has an impact on the price and quality of banking services in the host country (Cerutti *et al.*, 2007). The differences in organizational forms of foreign banks matter not just for the parent banks but also for regulators from the home and host countries. The literature characterizes the regulators' choice in the host country as a trade-off between efficiency and financial stability in choosing a specific organizational form of a foreign bank. Similarly, from the home country standpoint too, the division of responsibilities in terms of

supervision matter as during times of a crisis the boundaries get murkier and creates a lot of uncertainty.[19]

Thus the differences between the various organizational forms through which foreign banks can enter into EMDEs matter. A branch for instance is not an independent legal entity but an integral part of the parent bank. It may provide a full range of banking services and operates on the basis of the parent's full capital base. However, an affiliate on the other hand is an independent legal entity in which the foreign bank has less than majority ownership, whereas a subsidiary, much like an affiliate, is not only a separate legal entity incorporated in the host country but also where the foreign parent has the majority ownership. Given that there are no costs of incorporation, a foreign bank branch is cost-effective relative to setting up a subsidiary. But effective supervision is required from the parent bank's perspective because a branch is still a component of the parent bank and any "unauthorized trading" could result in the bankruptcy of the parent bank. A branch is predominantly used for conducting wholesale and corporate banking activities in host countries. A subsidiary, on the other hand, being an independent entity, may fail even though the parent bank is solvent, i.e., the parent bank has the legal option to walk away from the operation as the obligations are limited to the value of invested equity. In addition, subsidiaries can only make loans on the basis of its own capitalization. Thus subsidiaries are separate entities from their parent banks, while liabilities of the foreign bank branches will be covered by their parent banks.

Broadly, if one compares the distribution of branches versus subsidiaries operating in both advanced economies and the EMDEs, data shows that while branches outnumber subsidiaries in the advanced economies, the reverse holds for the EMDEs (Fiechter *et al.*, 2011). This could be suggestive that in terms of their regulatory preference, EMDEs prefer to have subsidiaries as they can have better control over regulating the institution, especially during times of distress than in the case of branches. Also since subsidiaries tend to rely on local deposits with their retail banking model, from the perspective of local financial development, they could prefer subsidiaries. However it is interesting why the option of full liability presented by the parent banks for the operations of their branches (the so-called "deep-pockets") will not be tapped by the EMDEs (Cerutti *et al.*, 2007). That is a question for future research, especially given that the incidence of crises tend to be higher in EMDEs (atleast was the case up until the GFC).

To conclude, the literature is not helpful in identifying if there should be a clear preference of a particular structure of foreign bank from either the host or home country perspectives, which points to the direction in which future research in this field should be headed. Broadly, it is likely that the home country regulators would prefer to

[19] Given the limited literature in this field, the following discussion draws upon the following papers which have useful discussions about various dimensions of branches and subsidiaries: Fiechter *et al.* (2011), Cerutti *et al.* (2007, 2010), Santoso (2006), Dell'Ariccia and Marquez (2010), Eisenbeis and Kaufman (2005), Hawkins and Mihaljek (2001) and Thi and Vencappa (2008).

be insulated from liabilities and hence would like their banks to operate as subsidiaries in economies characterized by risks. The host countries on the other hand have to choose between the benefits of having subsidiaries engaging in retail operations that would facilitate financial development versus the full guarantee of the parent bank with respect to their branching operations in times of a distress.

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