

Rajan, Ramkishen S.; Gopalan, Sasidaran

Article

Sales to Foreign Banks in Emerging Asia

CESifo DICE Report

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Rajan, Ramkishen S.; Gopalan, Sasidaran (2009) : Sales to Foreign Banks in Emerging Asia, CESifo DICE Report, ISSN 1613-6373, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 07, Iss. 3, pp. 29-33

This Version is available at:

<https://hdl.handle.net/10419/166973>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

SALES TO FOREIGN BANKS IN EMERGING ASIA

RAMKISHEN S. RAJAN AND
SASIDARAN GOPALAN*

Introduction

Until the mid 1990s emerging Asia's banking system remained heavily regulated and barriers to foreign competition were prohibitively high. However, in the aftermath of the East Asian crisis of 1997–98, financial sector restructuring has been an essential element of the structural adjustment programs in Indonesia, Korea, Thailand and the Philippines.¹ Broadly speaking, governments in the crisis-hit regional economies have attempted to restructure their financial systems by closing down commercial banks and finance companies, merging some existing institutions and nationalizing others, injecting public funds to recapitalize viable banks, putting in place systematic asset resolution strategies, as well as easing regulatory impediments to foreign bank entry. Other countries in the region, such as India and China, have also taken steps towards financial deregulation. This paper examines the *de jure* and *de facto* policies towards foreign bank entry in selected emerging Asian economies. For reasons of data availability, the focus here is limited to China, India, Indonesia, Korea, Malaysia, Thailand and the Philippines.²

De Jure openness of Asian banking systems

One of the most immediate motivations for undertaking this policy in most of the crisis-hit countries was the much-needed funds that foreign investors brought in to help recapitalize the banking systems. Beyond

the financing issues, however, it is becoming increasingly apparent that foreign competition brings with it additional benefits that may not be likely in the case of domestic competition as elaborated elsewhere.³

Several Asian economies have witnessed crucial regulatory changes in their financial sector following the Asian financial crisis of 1997–98. Most of the countries have come up with specific blueprints for restructuring their respective banking and financial sectors. While the details of these reforms obviously vary between countries, one of the central elements of this restructuring plan common to all the countries has been the move to ease the entry norms for foreign banks, though the timing and pace has varied considerably. Among the key regulatory changes that have taken place pertaining to foreign bank entry was the amendment of rules governing foreign equity limits in the domestic banking sector. These were dramatically altered in some of the hard-hit countries post crisis. While countries like Indonesia, Korea and Thailand raised their foreign ownership limits quite aggressively (almost to 100 percent with some caveats), others took a far more gradualist approach. While the Philippines allowed foreign banks to hold a 60 percent ownership stake in local banks, India raised its limit on foreign equity ownership from 49 percent to 74 percent. Malaysia seems to be the only country in the region not to have relaxed its foreign equity limits, holding on to its 30 percent or 49 percent limit depending on the scope and type of business. China had a relatively low ownership limit of 25 percent which is not surprising because it started the process of opening up its banking sector only after its entry into the WTO in 2001.

The aggressive liberalizers: Indonesia, Korea, Thailand and the Philippines

Indonesia, by virtue of being the hardest hit due to the Asian crisis, was quite pro-active in undertaking



* Ramkishan S. Rajan is a visiting senior research fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore and an associate professor at George Mason University, Virginia, United States. Email: isassr@nus.edu.sg or rrajan1@gmu.edu. Sasidaran Gopalan is a research associate at the Institute of South Asian Studies. Email: isassg@nus.edu.sg.

¹ For a detailed discussion of the restructuring of East Asia's financial sectors post-crisis, see Lindgren et al. (2000). For a more succinct overview, see Rajan and Bird (2002).

² We exclude Singapore and Hong Kong as they are regional financial centres.

³ For instance, see Gopalan and Rajan (2009) and references cited within.

full fledged restructuring of its financial sector following the crisis. The first step was to address the problems in the domestic banking system, which was done by setting up the Indonesian Bank Restructuring Agency (IBRA) in January 1998 to oversee mass consolidations of the badly hit domestic banks and also to address the issue of non-performing loans (NPLs) in state and private banks. In addition, the more significant regulatory change occurred when a new banking law came into existence in November 1998 that relaxed the restrictions on foreign participation in the country's domestic banking industry. The key elements of that law included permitting foreign banks to take over Indonesian banks and invest in unlisted and listed banks, subject to some restrictions,⁴ allowing foreign non-bank institutions to purchase Indonesian banks and removing the restrictions on the expansion of branches of foreign joint-venture banks. This move also allowed the IBRA to sell off the local banks that were nationalized (in order to prevent them from completely collapsing) during the crisis to the foreign firms. Due to this "divestment" programme, the country has seen a tremendous growth in the foreign ownership of the national banking system. Foreign banks in Indonesia constitute a sizeable presence in terms of their number. By the end of 2005, there were about 37 banks that could be classified as foreign banks in Indonesia, of which, 11 were foreign bank branches, 17 were joint ventures and 9 were foreign acquired banks. This said, the definition of a foreign bank does not include the private national banks which have significant foreign ownership stakes as well.

During the restructuring process post crisis, the Korean government pursued a policy of encouraging the entry of foreign banks and thereby easing all the regulatory obstacles that stood in their way. In 1998, the Financial Supervisory Commission (FSC) was established to oversee the financial sector restructuring and the FSC recognized the need for foreign participation to assist the country in the process of recapitalization and enhance the efficiency of the banking system. Foreign banks have also been allowed to establish subsidiaries in the country. Notwithstanding an initial spurt in overseas foreign banks to the Korean market immediately after the crisis, it was only post 2004 that the foreign bank entry through branches resumed in a significant way, and by the end of 2008 there were 39 foreign bank branches in South Korea.

⁴ Although the law does not yet permit foreign banks to establish new fully foreign-owned banks in Indonesia, foreigners can acquire 99 percent of existing banks' shares.

Thailand is the other aggressive liberalizer. The most important regulatory reform following the 1997–98 crisis was to allow 100 percent foreign ownership of the domestic financial institutions for a ten year period, after which the foreign banks will not be able to take up additional equity unless they hold less than 49 percent of the equity shares. This assumed more prominence mainly because of the severe restrictions that are in place for the foreign banks to gain market access through establishing branches. The Financial Sector Master Plan (FSMP) that was initiated in 2004 allows foreign banks to apply for two types of licenses. The first option is for a foreign bank to be a subsidiary whereby it enjoys the same scope of business as a commercial bank and is also allowed to open one branch within Bangkok and three branches elsewhere in Thailand. The second option is to apply for a full branch of a foreign bank, which has the same scope of business as a commercial bank but which is not allowed to open any branches. The minimum capital requirement is higher for a branch than a subsidiary. Foreign banks with majority shareholdings in Thai commercial banks are also allowed (so-called hybrid banks). Thailand had 3 hybrid banks, 16 foreign branch banks and 24 foreign banks that maintain representative offices as of February 2009.

While the Philippines has not been nearly as aggressive as the other three economies in terms of financial sector liberalization, its banking system too has undergone substantial restructuring following the crisis. Similar to its neighbours, in the year 2000, the general banking act was amended to facilitate the entry of foreign banks. This also resulted in a policy change which encouraged significant cross-border mergers and acquisitions in the financial sector. Foreign banks were allowed to acquire a 100 percent stake till the end of April 2007 after which the cap on ownership reverted to 60 percent.

The cautious liberalizers: India and China⁵

The liberalization of financial services in India has been gradually picking up since the early 1990s. Foreign banks are now allowed to access the Indian market not only through branches, but also as wholly owned subsidiaries. This was a significant component of the blueprint pertaining to widening the presence of foreign banks in the Indian market.⁶ Ag-

⁵ Malaysia would also be in this category of cautious liberalizers.

⁶ Entitled "Roadmap for presence of foreign banks in India", Reserve Bank of India 2005.
<http://www.rbi.org.in/upload/content/images/RoadMap.html>

gregate foreign investment limits in private domestic banks (only those identified by the Reserve Bank of India for restructuring) has been revised to 74 percent. India's regulatory environment is, in some cases, more favorable to foreign banks than the domestic banks, which is in contrast to most other countries in the region. For instance, there is no discriminatory treatment between a foreign bank and a domestic bank as far as the banking operations are concerned. A foreign bank can undertake all the activities open to an Indian bank, including both retail as well as wholesale banking business. In addition, there exists some form of a positive discrimination favouring foreign banks as regards the priority sector lending requirements.⁷

China has been a late entrant as far as opening up its banking sector to foreign participation is concerned. While most of the other Asian economies undertook more aggressive domestic liberalization than what they have offered under GATS, most of the recent developments with respect to foreign bank operations in China seem to have been primarily driven by obligations arising from China's entry into the WTO in 2001. Though there was a multilateral commitment for a phased expansion of foreign bank access since end 2006, the penetration level of foreign banks in China remains very small and even insignificant to some extent as the larger issue of complicated regulatory requirements still remains. While the direct participation of foreign banks as either branches or subsidiaries in the Chinese banking system is insignificant, indirect participation as investors with minority stakes has been gaining considerable popularity in recent years (Leigh and Podpiera 2006). Since 2003 the maximum share a single foreign investor may take in a local bank has been raised to 20 percent. The overall maximum foreign shareholding is set at 25 percent. There were about 70 banks with minority stakes in Chinese banks and close to 200 foreign banks had opened up representative offices in China as of end 2007. The regulations governing the establishment of foreign banks remain quite stringent compared to those of the other countries in the region.

⁷ Foreign banks are required to lend only 32 percent of net credit to priority sectors, as against the 40 percent requirement for Indian banks. Domestic banks also have a sub-ceiling in respect of agricultural advances as a part of priority sector lending, which is not applicable to foreign banks. Export credits that are granted by foreign banks would be adjusted towards the priority sector lending obligation, something not available for Indian banks.

⁸ The data for foreign bank assets are more easily available and hence more complete (and probably more accurate) than that of foreign bank deposits.

Significance of foreign banks in Asia

Overall, we see that much of Asia has taken important – though but by no means uniform – steps in opening up their banking systems to foreign competition. But to what extent have these regulatory changes translated into actual tangible or de facto changes? The evidence regarding the number and share of foreign banks in the domestic economy is somewhat counter-intuitive in that the number of foreign banks appear actually to have gone down in most of the countries despite the various regulations designed to ease the entry norms for foreign banks (Table 1). However, this has largely been because of major consolidations and domestic restructurings among local banks. More noteworthy would be to examine the extent of market share of foreign banks in terms of assets and liabilities. Table 2 offers some indicative evidence by providing the extent of penetration of foreign banks with respect to their share of total assets and deposits.⁸

The levels of foreign bank penetration have increased dramatically in Indonesia and Korea in particular, but also in Thailand and the Philippines to a somewhat lesser extent, especially in the case of foreign bank share of domestic assets. Not surprisingly, the penetration levels of foreign banks in China's domestic banking industry remained insignificant with just about two to three percent share of total banking assets at the end of 2007, though up from close to zero in 1997.

India and Malaysia are interesting cases. As Table 2 indicates, there was no substantial change in market share of foreign bank assets and deposits pre and post

Table 1
Number of foreign banks in emerging Asia

Country	During the crisis (1997) ¹⁾	Post crisis (latest year available) ²⁾
Indonesia	44	37 (2005)
Malaysia	14	13 (2008)
Thailand	21	16 (2008)
Philippines	13	22 (2008)
Korea	68 (1998) ³⁾	36 (2007)
China	n.a.	71 (2007)
India	42	29 (2007)

Notes: In addition to branches and subsidiaries, foreign banks here include minority stakes, joint ventures, etc. Figures in parentheses denote the latest available year for that country; n.a. = not available.

Source: 1: Taken from Chua (2003). – 2: Compiled from the EIU Country Finance Reports. – 3: Based on Oh and Park (1998).

crisis in both these countries. In fact the shares of foreign bank deposits have actually declined in both the countries, although marginally. This appears to be largely because of a rapid rise in the presence of private domestic commercial banks which have captured market share from national banks as well as foreign banks. The share of foreign bank assets and deposits in Malaysia have remained stable over the last decade. While India's regulatory policies seem to provide a conducive environment for the entry and operation of foreign banks, the significance of foreign banks in the domestic banking industry has actually been declining since 1997. The concomitant rise in the private sector banks in the country and the already existing state owned banks appear to be outpacing the foreign bank penetration rates. Specifically, the number of foreign banks operating in India has actually declined from 42 during 1997–98 to about 29 in 2007. While this was partly due to mergers between the Indian branches of foreign banks, there were also closures of some foreign banks in this period. As in Malaysia, domestic consolidations and privatizations were favoured over allowing foreign bank entry per se. Thus, the share of foreign bank assets in the total commercial banking assets stood at nearly 8 percent in 2007, almost on par with the levels during the 1997 financial crisis, while that of deposits declined from about 7 percent during 1997 to around 5.8 percent in 2008. On the other hand, as discussed in Gopalan and Rajan

(2009), the significance of private sector banks has been growing steadily since 1997 and they accounted for nearly 22 percent of the banking assets at the end of 2007, up significantly from about 10 percent in 1997. The same trend holds for deposits and the shares of deposits held by the private banks expanded significantly post crisis from about 8 percent to 20 percent in 2007.

Conclusion: Asia's continued anxieties with foreign bank entry

The evidence of efficiency and related gains to be had from foreign bank entry are fairly strong. This has motivated a number of emerging economies to welcome foreign banks into their domestic economy. While Asian banking systems have become far more internationalized over the last decade since the 1997–98 crisis, they still remain relatively closed compared to their Eastern European and Latin American counterparts. The relatively low penetration of banks into Asia (measured in terms of loans, deposits or assets) is consistent with the fact that while Asian economies have been deregulating their banking systems for reasons noted above, they have approached this process somewhat more cautiously than their counterparts in Eastern European or Latin America (for instance, see CGFS 2003). Part of this caution is the belief in some quarters in Asia that foreign banks

might be a source of instability and contagion rather than stability. This appears to have been the case in the recent global financial crisis which hit Eastern Europe's financial system much harder than it has the relatively more closed and regulated Asian financial system. Does foreign bank entry, or more broadly, internationalization of the financial sector, make the country prone to international capital booms and reversals and if so, under what circumstances? The evidence that a high share of foreign bank ownership may increase the likelihood that foreign shocks are transmitted domestically and may thus be a source of added vulnerability is mixed at best. Much more careful research needs to be done on this topic.

Table 2
Share of bank assets and deposits in emerging Asia by foreign banks with majority ownership (in %)

Countries	Share of banking assets		Share of banking deposits	
	1997 ¹⁾	2007–08 ²⁾	1997	2007–08
Indonesia	5.8	47 ³⁾ (2008)	4.9 ⁴⁾	6.1 ⁴⁾ (2002)
Malaysia	21.6 ⁴⁾	23 (2008)	21.1 ⁴⁾	20.8 ⁴⁾ (2008)
Thailand	7.1	12.6 (2008)	2.9 ⁴⁾	7.8 ⁴⁾ (2008)
Philippines	8.5	13.2 (2007)	n.a.	n.a.
Korea	2.2	15.7 (2008)	3.8 ⁵⁾	10 ⁵⁾ (2002)
China	0.1	2.3 (2007)	n.a.	n.a.
India ⁶⁾	7.9	8.5 (2008)	7	5.8 (2008)

Note: A bank is defined as foreign if it includes over 50 percent of shares. Figures in parentheses denote the latest available year for that country. n.a. = not available.

- Source: 1: Unless otherwise mentioned, all the banking assets data for the year 1997 is based on Cull and Peria (2007).
 2: Unless otherwise mentioned, all the data available for 2007–08 is based on EIU Country Finance Reports, latest available year.
 3: Based on the following link:
<http://www.thejakartapost.com/news/2008/09/10/editorial-foreignowned-banks.html>.
 4: Data compiled from CEIC Global Database.
 5: Data based on Kim and Lee (2004).
 6: Data on India compiled from Reserve Bank of India (RBI) documents; Prasad and Rao (2005).

References

- Committee on the Global Financial System (CGFS) (2003), "Financial Sector FDI in Asia – Brief Overview", Mimeo, 1–2.
- China Banking Regulatory Commission (2006), Regulations for the Administration of Foreign-funded Banks, <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2871>.
- Chua, H. B. (2003), "FDI in the Financial Sector: The Experience of ASEAN Countries Over the Last Decade", Monetary Authority of Singapore.
- Cull, R. and M. Peria (2007), "Foreign Bank Participation and Crises in Developing Countries", *World Bank Policy Research Working Paper* no. 4128.
- Economist Intelligence Unit, Country Finance Reports, various years.
- Gopalan, S. and R.S. Rajan (2009), "Foreign Bank Entry in Emerging Asia", *Institute of South Asian Studies Working Paper* no. 76, National University of Singapore, July 2009.
- Kim, H. E. (2005), "Domestic Financial Liberalization, Stabilizing Effects of Foreign Bank Entry, and Challenges to Bank Supervision: The Korean Experience", Bank of Korea.
- Kim, H.E. and B.Y. Lee (2004), "The Effects of Foreign Bank Entry on the Performance of Private Domestic Banks in Korea", Bank of Korea.
- Leigh, L. and R. Podpiera (2006), "The Rise of Foreign Investment in China's Banks – Taking Stock", *IMF Working Paper* no. 06/292.
- Lindgren, C. J., T.J.T. Baliño, C. Enoch, A. M. Gulde, M. Quintyn and L. Teo (2000), "Financial Sector Crisis and Restructuring Lessons from Asia", IMF, Washington, DC.
- Oh, J. and D. Park (1998) "Financial Reform and Financial Crisis in Korea", *Nanyang Technological University Working Paper* no. 8.
- Prasad, C. and K. S. S. Rao (2005) "Sustainability of Foreign Banks in India – A Statistical Analysis", ICAFI Conference Paper.
- Rajan, R. S. and G. Bird (2002), "Still the Weakest Link: The Domestic Financial System and Post-Crisis Recovery in East Asia", *Development Policy Review* 19, 355–66.
- Reserve Bank of India (2005), Roadmap for Presence of Foreign Banks in India, <http://www.rbi.org.in/upload/content/images/RoadMap.html>.