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Financial Sector De-Regulation in Emerging Asia: Focus on Foreign Bank Entry

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1. Introduction

Over the last decade many emerging Asian economies have been liberalizing their financial sectors, including opening up their banking systems to foreign competition. One of immediate motivations for undertaking this policy in many countries like Indonesia, Korea and Thailand was the much-needed funds that foreign investors might bring in to help recapitalize the banking systems following the Asian crisis of 1997-98. Beyond the financing issues, however, it is becoming increasingly apparent that foreign competition tends to bring with it additional benefits that may not be likely in the case of domestic competition.

First, there is growing body of empirical evidence of the benefits of foreign bank entry in emerging economies by way of reductions in cost structures, improvements in operational efficiency, introduction and application of new technologies and banking products, marketing skills and management and corporate governance structures.[2] 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. Customers should in turn benefit in terms of being able to access new financial services.

Second, bank internationalization may create domestic pressures for local banking authorities in the host countries to enhance and eventually harmonize regulatory and supervisory procedures and standards and the overall financial infrastructure to international best practice levels.[3]

Third, entry of foreign banks ought to reduce the extent of "non-commercial" or "connected" lending as these banks are not as politically connected as the home-grown institutions and therefore less susceptible to political patronage.[4]

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[2] For instance, see Levine (1996); Claessens and Glaessner (1998); Claessens et al., (1998); Also see Tamirisa and Sorsa (2000).

[3] See Kono and Schuknecht (1999).

[4] Kroszner (1998).

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Fourth, opening up of the domestic banking sector to foreign participation might encourage some of the local banks to venture overseas to compensate for loss of domestic revenue sources or mote generally because they have learnt from the experiences of their foreign competitors who have entered the local market. Thus, as Singapore's domestic banking system has become more internationalized since 1997-98, local banks in Singapore have both consolidated their operations while also aggressively expanded their operations overseas and been active participants in cross-border mergers and takeovers. Singapore banks, for instance, have purchased significant stakes in banks in India, Hong Kong, Thailand, the Philippines and Indonesia, just to name a few.[5] Similarly, India's largest bank, the State Bank of India (SBI), has been aggressively establishing ventures overseas in recent years just as the domestic market in India has become more open to foreign banks.[6]

Fifth, a banking system with an internationally diversified asset base may be more likely to be stable and less crisis-prone. There is evidence, for instance, that the foreign bank branches have lower non-performing loan (NPL) ratios than domestic banks in Korea, Malaysia and Thailand.[7] In addition, the domestic branches of foreign banks may be able to obtain financing from the foreign head office which could act as a private lender of last resort during a period of financial stress.[8] This said, it is important to ensure that foreign investments do not largely originate from a single home country as this might increase rather than decrease instability. Diversification of exposure is the key to enhancing financial stability.[9] (However, recent lessons of experience have given policymakers and observers some reason to revisit this oft-noted advantage of foreign bank entry; we return to this issue in sections below).

The remainder of the paper is organized as follows. Sections 2 and 3 respectively examine the extent of *de jure* and *de facto* policies in Asia with regard to the introduction of greater foreign competition. While there has clearly been greater international financial liberalization in the region, Asia lags behind emerging Europe and Latin America when it comes to the relative significance of foreign banks in their respective domestic economies. Section 4 discusses Asia's relatively cautious approach towards this policy. Section 5 concludes the paper. For reasons of data availability, the focus of this paper is limited to selected emerging Asian economies, viz. China, India, Indonesia, Korea, Malaysia, Thailand and the Philippines.[10]

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[5] For discussions of the overseas expansion of Singapore's largest domestic banks, see Tschoegl (2001) and IMF (2005). A caveat is in order. Some observers have argued that Singapore still appears to be hesitant in allowing greater foreign banks into their countries from countries like India citing inadequate prudential standards despite Indian banks being relatively strong by international standards.

[6] For instance, see http://www.thehindubusinessline.com/2009/05/10/stories/2009051050840300.htm. For more discussion of India's overseas investments in general, see Rajan (2009).

[7] Negishi and Inoguchi (2006).

[8] Claessens and Glaessner (1998).

[9] In view of this, trade agreements which give preferential access to foreign banks from only one or two countries (something that could happen with bilateral trade agreements) should be eschewed in favour of a more broad-based liberalization on a multilateral basis.

[10] We exclude Singapore and Hong Kong as they are regional financial centres.

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2. *DE JURE* OPENNESS OF ASIAN BANKING SYSTEMS

Several Asian economies have witnessed crucial regulatory changes in their financial sectors post the Asian financial crisis. 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 the restructuring plans common to all the countries has been the move to ease the entry norms for foreign banks, though the timing and pace has varied quite considerably. One of the key regulatory changes that took 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, others like Malaysia took a more gradualist approach. Table 1 presents a snapshot view of the key regulatory changes that have taken place in Asia between 1998 and 2008. We discuss a few details below.

2.1 *THE ENTHUSIASTIC 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 taking to 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 deal with 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 investing in unlisted and listed banks, subject to some restrictions,[11] 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. This 'divestation programme' appears to have yielded the desired results as the country has seen a tremendous growth in the foreign ownership in 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

[11] Although the law does not yet permit foreign banks to establish new fully foreign-owned banks in Indonesia, foreigners can acquire 99 per cent of existing banks' shares.

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TABLE 1: KEY REGULATORY CHANGES CONCERNING FOREIGN BANK ENTRY IN EMERGING ASIA

Country	Blueprint Pertaining to Foreign Bank Entry	Foreign Equity Ownership		Branch versus Subsidiary – Key Differences in Rules	Comments
		Pre-Crisis (1996/97)	Post-Crisis (2007/08)		
China	Regulations for the Administration of Foreign-funded banks (November 2006)	Not Available	20 percent – single foreign investor 25 percent – overall investment limit.	Minimum asset requirement higher for a branch than a subsidiary/ joint venture bank. Branches not allowed to do retail business while subsidiaries are eligible to do so.	Foreign Banks are encouraged to have local incorporation. Those banks that do not do so will not be allowed to accept deposits of less than Rmb1m
India	Roadmap for presence of foreign banks in India (2005)	49 percent	74 percent	Foreign banks can establish presence either through branches or as a 100 percent wholly owned subsidiary (WOS). Existing branches can convert into a WOS.	The foreign banks must lend 32 per cent of their net credit to priority sectors. Can do so by granting export credit.
Indonesia	New Banking Law (November 1998)	49 percent	100 percent	Foreign bank subsidiaries and branches are not governed by different regulations.	No new licenses are being granted to branches or subsidiaries of foreign banks.

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TABLE 1: CONT

Country	Blueprint Pertaining to Foreign Bank Entry	Foreign Equity Ownership		Branch versus Subsidiary – Key Differences in Rules	Comments
		Pre-Crisis (1996/97)	Post-Crisis (2007/08)		
					The already existing foreign branches and joint venture banks are allowed to open one additional sub-branch and one additional office.
Thailand		25 percent	100 percent	A foreign bank subsidiary is allowed to open one branch within Bangkok and three branches elsewhere. A full branch of a foreign bank cannot open any branches.	100 percent foreign equity ownership only for 10 years after which the foreign investors will be allowed to purchase additional shares only if their stakes fall below 49 percent
Korea	Modified Banking Law (1998)	49 percent	100 percent	The capital structure, entry and exit regulations are different for branches.	Financial Supervisory Commission needs to approve when foreign ownership stakes exceed 10, 25 and 33 per cent up to 100 per cent.
Malaysia	Master Plan (2001)	30 percent	30 percent	There are no foreign bank branches. New branches or ATMs not allowed.	Already existing subsidiaries were allowed to open 4 additional branches in 2006.

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TABLE 1: CONT

Country	Blueprint Pertaining to Foreign Bank Entry	Foreign Equity Ownership		Branch versus Subsidiary – Key Differences in Rules	Comments
		Pre-Crisis (1996/97)	Post-Crisis (2007/08)		
				All foreign banks are required to be locally incorporated – viz. they have to be subsidiaries.	
Philippines	General Banking Law (2000)	60 percent	60 percent	No specific differences in regulations governing branch and subsidiaries.	Since 2000, foreign bank subsidiaries can enter into the country only by purchasing an existing domestic bank.

Source: Authors' compilations based on the following documents – EIU Country Finance Reports (various years), East Asia Analytical Unit Report (1999), Marchetti (2009) and Pasadilla (2008).

ownership stakes as well. While foreign bank subsidiaries and foreign bank branches are not governed by different regulations, currently there are no new licenses that are being granted to either of the two, though the already established foreign branches and join venture banks are allowed to open one additional sub-branch and an additional office in the country.

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. If foreign ownership of domestic commercial banks exceeds 10, 25 and 33 per cent successively, it needs approval. Apart from allowing for greater foreign ownership, foreign banks have also been allowed to establish subsidiaries in the country. An interesting point worth noting is that the modified banking law in 1998 resulted predominantly in easing foreign investment through Mergers & Acquisitions (M&A) in Korean banks than through opening of

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foreign bank branches. 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 (Kim, 2005). At the end of 2008 there were totally 39 foreign bank branches in South Korea. That said, it is important to note that the local foreign bank branches are still governed by some stringent regulations that limit the participation of wholly foreign-owned banks in Korea.

Thailand is the other aggressive liberalizer. The most important regulatory reform following the 1997-98 crisis was to allow 100 per cent foreign ownership of the domestic financial institutions for a ten year period, after which the foreign banks would not be able to take up additional equity unless they held less than 49 per cent of equity. This ruling 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 started in 2004 allows the 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, it has undergone a substantial restructuring of its banking system following the crisis. Similar to its neighbours, in 2000, the general banking act was amended to facilitate the entry of foreign banks. This also resulted in a favourable policy change towards encouraging significant cross-border M&As in the financial sector. Foreign banks were allowed to acquire a 100 per cent stake till the end of April 2007, after which the cap on ownership reverted back to 60 per cent.

2.2 The Cautious Liberalizers: China and India[12]

The case of China seems to be very different when compared to the experiences of other countries in the region. China has been a relatively late entrant as far as opening up its banking sector for foreign participation is concerned. While most of the other Asian economies undertook more aggressive domestic liberalization than what they have offered under the GATS (noted below), most of the recent developments with respect to foreign bank operations in China have been primarily driven by obligations

[12] Malaysia is also in this category of cautious liberalizers with minimal changes during the period under consideration.

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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 (Leigh and Podpiera, 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 persists.

While the direct participation of the 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 the recent years (Leigh and Podpiera, 2006). Since 2003 the maximum share a single foreign investor may take in a local bank was 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. Only those foreign commercial banks that have maintained a representative office in China for at least two years prior to the application, and have total assets of not less than US $10 billion at the end of the year preceding the application, can apply for establishment of a wholly foreign-funded bank (subsidiary). The same asset requirement applies for the establishment of a Chinese foreign joint-venture bank and the asset requirement is even higher for the establishment of a branch. Foreign banks are encouraged to have local incorporation. Those banks that do not incorporate locally will be barred from accepting individual deposits of less than Rmb 1 million, (in a way severely limiting the scope of their business). As of end-2007, 24 foreign banks had incorporated locally. It is to be noted that since 2003 the maximum share a single foreign investor may take in a local bank had been raised to 20 per cent. The overall maximum foreign shareholding is set at 25 per cent. At the end of 2007, a total of 25 Chinese commercial banks had entered into partnerships with foreign investors.

The liberalization of financial services in India has been gradually picking up pace since early 1990s. Compared to China, India's regulatory environment has been reasonably liberal since then and in some cases has even been more favourable to foreign banks than to domestic banks, which is in sharp contrast with the 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 permitted to an Indian bank, including both retail as well as wholesale banking business. In addition, there exists some form of positive discrimination favouring foreign banks as regards the priority sector lending requirements. Foreign banks are required to lend only 32 per cent of net credit to priority sectors, as against the 40 per cent requirement for the Indian banks. The domestic banks also have a sub-ceiling with respect to agricultural advances as a part of priority sector lending, which is not applicable to foreign banks. Export credit that is granted by the foreign banks would be adjusted towards the priority sector lending

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obligation, something not available for the Indian banks. Importantly, 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.[13] Aggregate foreign investment in private domestic banks (identified by the Reserve Bank of India (RBI) for restructuring) has been revised to 74 per cent.

3. Penetration Rates 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 (excluding the Philippines) despite the various regulations designed to ease the entry norms for foreign banks (Table 2). 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 3 offers some indicative evidence on this by providing the extent of penetration of foreign banks with respect to their share of total assets and deposits.[14]

Table 2: 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	NA	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.
NA - Not Available
Source: 1 Taken from Chua (2003).
2 Compiled from the EIU Country Finance Reports.
3 Based on Oh and Park (1998).

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

[14] Data for foreign bank assets are more easily available and hence more complete (and likely accurate) than that of foreign bank deposits.

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TABLE 3: SHARE OF BANK ASSETS AND DEPOSITS IN EMERGING ASIA BY FOREIGN BANKS WITH MAJORITY OWNERSHIP

Share of Banking Assets (percent)			Share of Banking Deposits (percent)	
Countries	1997[1]	2007-08[2]	1997	2007-08
Indonesia	5.8	47[3] (2008)	4.9[4]	6.1 (2002)
Malaysia	21.6[4]	23 (2008)	21.1[4]	20.8[4] (2008)
Thailand	7.1	12.6 (2008)	21.1[4]	7.8[4] (2008)
Philippines	8.5	13.2 (2007)	NA	NA
Korea	2.2	15.7 (2008)	3.8[5]	105 (2002)
China	0.1	2.3 (2007)	NA	NA
India[6]	7.9	8.4 (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. NA – Not Available.
Source: 1 Unless and otherwise mentioned, all the banking assets data for the year 1997 is based on Cull and Peria (2007).
2 Unless and 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 central banks documents.
5 Data based on Kirn and Lee (2004).
6 Data on India compiled from Reserve Bank of India (RBI) documents; Prasad and Rao (2005).

The levels of foreign bank penetration have increased dramatically in Indonesia and Korea in particular, but also 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 a 2.3 per cent share of total banking assets at the end of 2007, though up from almost zero in 1997. India and Malaysia are interesting cases. As Table 3 indicates, there was no substantial change in the market share of foreign bank assets and deposits pre and post crisis in both these countries. Infact the share of deposits of the foreign banks actually declined in both the countries, although marginally. This appears to largely be because of a rapid rise in the presence of private domestic commercial banks which have taken the market share from national banks as well as foreign banks.

In Malaysia, the restrictions on foreign participation in its banking sector were largely maintained post crisis. The share of foreign bank assets in Malaysia improved marginally from 21.6 per cent in 1997 to about 23 per cent in 2008 while those of deposits remained stagnant. As Table 4 highlights, private domestic commercial banks controlled nearly 78 per cent of the banking assets and deposits in the country during the time of the crisis and this structure of the Malaysian banking system has largely continued to remain so even after 10 years following the crisis. Given the overwhelming significance of the private domestic banks compared to foreign banks, mainly arising out of a favourable policy by the government to encourage domestic consolidations and privatizations, it was difficult for the foreign banks to expand their presence in Malaysia.

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TABLE 4: DOMESTIC PRIVATE COMMERCIAL BANK ASSETS AND DEPOSITS IN INDIA AND MALAYSIA

	India		Malaysia	
	Share of Banking Assets (percent)	Share of Banking Deposits (percent)	Share of Banking Assets (percent)	Share of Banking Deposits (percent)
1997-98	10.1	8.3	78.8	78.1
2007-08	21.7[1]	20.3[1]	76.9	79.1

Source: 1 Compiled from Reserve Bank of India and Bank Negara Documents.

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 largely because of the rise in the private domestic banks. 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 to allowing foreign bank entry per se. Thus, the share of foreign bank assets in the total commercial banking assets stood at nearly 8 per cent in 2007, almost on par with the levels during the 1997 financial crisis, while that of deposits declined from about 7 per cent during 1997 to around 5.8 per cent in 2008. On the other hand, as shown in Table 4, the significance of private sector banks has been growing steadily since 1997 and they accounted for nearly 22 per cent of the banking assets at the end of 2007, up from about 10 per cent in 1997. The same trend holds good for deposits and the shares of deposits held by the private banks expanded significantly post crisis from about 8 per cent to 20 per cent in 2007.

It is instructive to note here that the multilateral commitments of almost all these economies have been bound at lower levels than what has been liberalized autonomously. For instance, India's multilateral commitments at the WTO in the banking sector came into force soon after the Asian financial crisis (1997-98) and the obligations concerning issuing of new licenses for foreign bank entry were limited to 12. Also, as per the commitments, India could deny issuances of new licenses to foreign banks if their share of assets (including both on and off balance sheet items) exceed 15 per cent. But it has been well documented that the Reserve Bank of India (RBI) has been far more liberal in granting entry for more foreign banks than the levels bound at the multilateral level, and it has also not denied licenses to any new foreign bank using the WTO provisions till date. The foreign equity limits have also been raised autonomously to 74 per cent as opposed to the 49 per cent that was bound in the revised offers. These instances indicate that the multilateral commitments have actually lagged behind the autonomous liberalization measures taken with respect to foreign bank entry.

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4. Asia's Continued Anxieties with Foreign Bank Entry

Overall while foreign banks have made some inroads into emerging Asia, especially Indonesia, Korea and Thailand, the extent of penetration of foreign banks in Asia as a whole has been relatively low compared to that of Central or Eastern European and Latin American countries. For instance, a report by the Committee on the Global Financial System (CGFS) made the following observation:

> One of the features that differentiate Asia from other emerging market economies is the limited degree of foreign participation in the domestic banking sector. .. (T)he share of foreign bank assets in Asia, at about 10 percent, is far smaller than 33 percent in Latin America and over 50 percent in Eastern Europe. In Latin America and Eastern Europe, a series of "mega" takeovers have led to a significant foreign bank presence in many countries, frequently with a large portion of the banking system owned by foreign institutions. The average size of cross-border financial sector M&A deals during the last five years was around $40 million in Asia, considerably smaller than that of around $187 million in Latin America. This mostly reflects the fact that in Asia, many takeovers were either purchases of small financial institutions or acquisitions of minority stakes, with the exception of Thailand.[15]

While Asian economies have been deregulating their banking systems for reasons noted above, they have, as a group, approached this process somewhat more cautiously than their counterparts in East European or Latin American. Part of this caution may be attributable to the continued presence of a strong anti-foreign bank lobby in some Asian countries. While some of the criticisms are misplaced and part of a larger "globophobia" phenomenon, there are some valid concerns with this policy.[16]

For some time, the conventional wisdom has been that a banking system with an internationally diversified asset base may be more likely to be stable and less crisis-prone. There is evidence, for instance, that the foreign bank branches have lower NPL ratios than domestic banks in Korea, Malaysia and Thailand. In addition, the domestic branches of foreign banks may be able to obtain financing from the foreign head office which could act as a private lender of last resort during a period of financial stress. A growing concern is 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 European 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? Many casual observers of financial liberalization fail to make a distinction between "capital account deregulation" (such an external borrowing), on the one hand, and "internationalization of the financial sector", on the other. The latter is broadly defined

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[15] The Committee on the Global Financial System is a central bank forum established by the Governors of the G10 central banks to monitor and examine broad issues relating to financial markets and systems. See CGFS (2003). Also see RBA (2003). See *The Economist* (February 8, 2003) for a general survey of Asian financial systems post-crisis.

[16] This section builds upon Rajan and Gopalan (2009).

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as the elimination of barriers to entry and discriminatory treatment of foreign competition and cross-border provision of financial services.

The nexus between international capital flows and financial services may be succinctly and effectively captured by Table 5. 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. Cell IV on the bottom right-hand side denotes the case of "complete" international financial liberalization, i.e. liberal capital account and bank internationalization. The remaining two cells may be broadly classified as "partial international financial liberalization". Specifically, Cell II involves the case of bank internationalization with capital restrictions; while Cell III is the case of capital account deregulation but with restrictions on trade in banking services maintained (e.g. foreign bank loans). Of course, in reality, matters are not nearly as simple; the two elements of international financial liberalization are closely intertwined and cannot be cleanly separated. Nonetheless, the assumption of total separability is useful conceptually.[17]

The General Agreement on Trade in Services (GATS) recognizes the right of countries to maintain sovereignty over prudential and related regulations of all financial firms resident in the country, including capital account controls. It is more likely that capital account in the forms of foreign bank lending makes a country relatively more crisis-prone than when a foreign bank establishes a separate entity in the host country of lends domestically, especially in the form of a fully independent subsidiary (as opposed to a branch or representative office). This said, much more research is needed on the relative costs and benefits of branches versus subsidiaries, the latter being relatively independent from the parent.[18] For instance, are the former more likely to be supported by their parent in the event of a crisis in the host country but also more likely to "cut-and-run" in the event of a crisis in the source country or a global crisis? While research

TABLE 5: 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 only.*
Loan involves international capital only	Cell III: *International capital flows only.*	Cell IV: *Financial services trade and international capital flows.*

Source: Kono and Schuknecht (1999).

[17] For a discussion of the nexus between foreign bank entry and Capital account regulation, see Kono and Schuknecht (1999) and Tamirisa (1999). The latter study finds that while financial service liberalization in general has insignificant effects on capital inflows, different modes of entry and different types of financial services (e.g. banks versus insurance) could have differential effects on capital flows. There is evidence that the former inevitably leads to *de facto* weakening of capital controls. For some evidence of this in the case of China, see Liu (2005).

[18] See Clarke et al., (2003) and World Bank (2008).

on the mode of bank lending is scant, one would also expect that domestic lending via an onshore foreign bank would more likely be in bgdomestic currency, while offshore lending would be in foreign currency (like US dollars), hence leaving the country more vulnerable to currency mismatches and financial crisis (i.e. negative balance sheet effects).

Beyond this, the other broad economic justifications for continued protection of the domestic banking system boil down to the usual "infant industry" and "strategic" industry arguments. The first ‘ essentially argues that time is needed for domestic bank consolidation if local banks are to be able to compete effectively against multinational foreign banks which have much larger and more diversified capital bases. The second maintains that the financial sector, with its intricate linkages to the rest of the economy, is "too important to be left in the hands of foreigners".

While the infant industry argument has merit in theory, as is usually the case, the problem in practice is that most infants take too long to grow up, and many a times they grow old rather than grow up. The other problem with infant industries is that since they form a dependency on the state to protect them all the time from threats, it tends to make them become fairly inefficient and it is usually the consumer who usually loses out at the end. With regard to the strategic industry argument, one could turn it on its head and suggest that, in view of the importance of the banking and overall financial sector to the rest of the economy and society, everything possible must be done to ensure it is as efficient as possible, and that include welcoming foreign bank participation. In any event, as with most other industries, the infant and strategic industry arguments appear more valid as grounds for moderating the pace and possibly even the extent of foreign bank entry, rather than opposing the policy in its entirety. From the regulators perspective, any form of financial services liberalization requires that the institutional and regulatory environment be fortified before and during the process of liberalization. Liberalization in a weak or ineffective regulatory and supervisory environment can be calamitous. This was made abundantly clear by the East Asian crisis of 1997-98 which was partly caused by the ill-timed and ill-sequenced liberalization of the financial sector. This is an important reason to favour introducing competition in a phased and nuanced manner.

There are other reasons for a gradual as opposed to "cold turkey" or "big bang" approach to bank internationalization. The long sheltered and coddled local banking sector usually needs some "breathing space" and lead time to prepare for the impending competition. This in turn necessitates a broad consolidation of many of the hitherto relatively weak and small banks and non-bank financial institutions via mergers or takeovers. Absent this, apart from outright closures of some smaller and inefficient banks, remaining domestic banks may opt for increasingly risky and speculative investments to compensate for declining market shares, lower profit margins and eroding franchise values. If such "gambling for redemption" occurs, an increase in bad loans due to risky investments will partially offset the efficiency gains associated with greater international

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competition. In addition, foreign banks may, in some instances, be in a position to engage in "cherry picking", i.e. being able to choose clients/debtors of highest quality and leaving the domestic banks to serve lower quality borrowers. There is some evidence that this has been happening in some Asian countries like Korea and India.[19]

This said, the danger of a gradualist approach to internationalization is that it may eventually "run out of steam" as opponents of the program will have more opportunities to block it. Lest there be any wavering of commitment by Asian policy makers to bank internationalization, it is imperative to keep in mind that what matters for growth and welfare is the availability of high quality products and services at internationally competitive prices, not who provides them. It warrants repeating that the need for efficiency in banking services is paramount as it is a key input in all other sectors of the economy. This point needs to be reinforced in Asia where, despite noteworthy steps having been taken to lower barriers and encourage foreign participation in their domestic banking sectors, the region's banking sectors remains somewhat less internationalized than their counterparts in Latin American and Eastern Europe. Indeed, many Asian countries, especially China and India, are only at the early stages of internationalizing their banking and financial systems.

One outstanding concern of deregulating of the domestic banking system that has gained greater credence recently is that it could weaken the ability of the central bank to use "moral suasion" in times of crisis. For instance, the ongoing financial crisis has made apparent the lack of effectiveness of conventional monetary policy, due in part to the fact that liquidity infusions by many central banks into the domestic financial system have remained clogged up without being passed on to the real economy in terms of bank lending (hence resulting in a sharp decline in the money multiplier). However, this has been somewhat less of a problem is some Asian economies such as India and China with large public sector dominated banks (*de facto* or *de jure*) as the central banks in these countries have been able to "cajole" the domestic commercial banks to lower lending rates and increase lending to the private sector.[20]

5. Conclusion

The evidence of efficiency and related gains to be had from foreign bank entry is fairly strong. This has motivated a number of emerging economies to welcome foreign banks into the domestic economy. While Asian banking systems have become 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. As discussed above, many of concerns of foreign bank

[19] For Korea, see Kim and Lee (2004). For India, see Gormley (2006).

[20] Islam and Rajan (2009) discuss this bank lending channel during the ongoing global financial crisis with specific focus on India. The World Bank (2008) finds that a higher presence of foreign banks tends to reduce the transmission of policy interest rates as foreign banks may be less sensitive to domestic monetary conditions.

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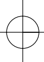
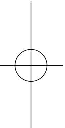
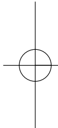
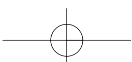


entry are arguably more to do with the timing and pace of the deregulation process as well as the mistaken belief that foreign bank entry is synonymous with capital account deregulation. The evidence that a high share of foreign bank ownership may lead to greater likelihood of foreign shocks to be transmitted domestically and thus be a source of added vulnerability, is mixed at best and much more careful work needs to be done on this topic.

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