THE IMPACT OF FOREIGN BANKS ENTRY ON DOMESTIC BANKS FINANCIAL PERFORMANCE: AN OVERVIEW

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ABSTRACT

The purpose of this study is to establish a synthesis on the literature of foreign banks entry and its linkage to the domestic banks of less develop, developing and developed countries financial performance. Foreign banks entry is associated with the number of foreign banks entry and total assets share of foreign banks entry in the domestic banking sector. Whilst the financial performance is focusing on the domestic banks' profit, net interest margin, non-interest income, overhead cost and loan loss provision. Foreign banks entry has been acknowledged in the literatures as instigating certain impact on domestic banks financial performance. Increases in the number of foreign banks entry or total assets shares of foreign banks entry in the domestic banking sector are associated with higher competition to domestic banks. Thus, the impact might be positive or negative to domestic banks financial performance, depend on how well developed the host countries' banking sectors and economics are. A literature search concerning the impact of foreign banks entry on the domestic banks financial performance was undertaken using online journal data bases where the articles were thoroughly reviewed. Foreign banks entry was associated with different impacts on less develop, developing and developed countries domestic banks financial performance. For instance, those strong and great reputations of foreign banks entry have created unbalance competition between foreign banks entry and domestic banks of less developed and developing countries. Thus, foreign banks entry imposes negative impacts on domestic banks financial performance of developing and less develop countries due to the inability of domestic banks to innovate, imitate and compete with the foreign banks entry advance innovations, technology and system. Nevertheless, foreign banks entry has less significant impact on domestic banks financial performance of developed country since the potential of domestic banks of developed country to learn on banking innovations, technology and system from foreign banks entry is not high.

***Keywords**: Foreign banks entry, domestic banks, financial performance*

1. INTRODUCTION

Financial market liberalisation and the elimination of banking sector regulatory barriers in domestic host countries which previously restricted the entry of foreign banks have inspired foreign banks internationalization; foreign banks expanded their banking activities abroad, since decades ago. Foreign banks entry are normally great banks with excellent reputations as they have strong capitalized financial backing from their parent bank which provides a firm financial support to prevent any liquidity shocks during financial crisis, executes excellent management practices in their banking business activities and possesses with highly modern banking skills and advance banking technology system of banking operations (Claessens et. al., 2001).

The substantial growth of foreign banks entry in the domestic banking sector raises an interesting question about the impact of foreign banks entry on the domestic banks financial

performance. Numerous researches have been carried out to study the impacts of foreign banks entry on the domestic banking sector. Those studies could be classified in two categories: firstly, are studies that analyse the impacts of foreign banks entry across countries and secondly are studies that focused on the impacts of foreign banks entry in particular countries. Both studies that is made in many countries and in a particular country, indicates that foreign banks presence in domestic banking sector has influenced competitiveness in the domestic banking sector, which simultaneously stimulates the domestic banks to enhance their efficiency, thus influencing on the financial performance of domestic banks. Hence, those studies are executed which focus on the impacts of foreign bank entry on domestic bank financial performance; profitability, costs and incomes, interest margins and loan loss provisions.

2. WHY FOREIGN BANKS EXPAND ABROAD?

The expansion of foreign banks entry into domestic banking sector abroad is on the basisof new market seeking. It is on the premise that the gains obtained from domestic banking sector abroad may compensate any losses or decreases of earning at their home country. Furthermore, the most important attribute is that, foreign banks entry is inspired by the competitive advantages of the domestic banking sector abroad that possesses financial stability, higher expected returns and potential of economic growth (Clarke et al., 2003).

Besides that, foreign banks extend abroad with the customer following motives. Foreign banks follow their valuable conglomerate customers that expand their business abroad or oversea. The foreign banks do not want to lose their remarkable profit from their valuable conglomerate customers in their home country. The foreign banks are unwilling to let the huge profit that can be generated from their valuable conglomerate customers to domestic banks abroad (Aliber, 1984).

3. MODES OF FOREIGN BANKS ENTRY

In facilitating such internationalization of banking activities, many foreign banks have expanded internationally by entering domestic banking sectors abroad through establishing foreign subsidiaries and branches, mergers or by taking over (acquisition) domestic banks abroad (Aliber,1984). Hence, foreign banks are said of entering the domestic banking sector either via acquisition of domestic banks or through green field investment.

The extent to which foreign n bank subsidiaries differ from domestic banks will also depend on theirlevelofembeddednessinthemultinationalbankingorganisationthey are part of. A useful distinction in this regard is the one between *denovo* foreign bank affiliates, so called greenfield, and affiliates that are the result of a takeover of an already existing bank. Greenfields and takeovers may differ because they reflect differing entry strategies of the parent bank (Levine, 1997). A foreign bank unfamiliar with a country to which its wants to expand may first establish a green field to 'test the waters'. Buying an existing bank may on the other hand reflect a longer term or more definite commitment (Bonin et al., 1998).

Moreover, some parent bank establishes green field because they want to control all aspects of the new affiliate right from the beginning. Other banks put more emphasis on the need to be a real local bank, and are thus more in favour of taking over an existing bank (Levine and Zervos, 1998). In that case, however, the strategic direction and balance sheet composition n of takeovers may for some time partly reflect the influence of the former management (Schranz, 1993). This will especially be the case when local management and staffs is not or only partly replaced (Rajan and Zingales, 1998). In general, the organisation a land corporate

governance links between a parent bank and a takeover are likely to be looser than those between a parent bank and the green field it has established from scratch (Berger et al., 2000).

4. THE ADVANTAGES OF FOREIGN BANKS ENTRY ON DOMESTIC BANKS FINANCIAL PERFORMANCE

Foreign banks entry has leads to the introduction of efficient banking management practices, latest banking technologies and financial innovations previously unknown to domestic banks. These are beneficial to domestic banks since management team of domestic banks could learn and adopt those efficient banking management practices, latest banking technologies and financial innovations of foreign banks entry to improve the operations of their banks (Clarke et al., 2003). As such, increased competition stimulated by new entrants of foreign banks entry has push and initiate domestic bank to become more efficient in their banking business operations (Barth et al., 2004)

Foreign banks entry encourages improvement domestic banks efficiency through sound competition as foreign banks entry represents competitive competition for domestic banks. Hence, it might cause dynamic impact on domestic banks financial performance; profitability, net interest margin, non-interest income, overhead cost and loan loss provision (Claessens, 2001). However, it’s depend on how well developed the host countries’ banking sectors and economics are (King and Levine, 1993; Lensink and Hermes, 2004).

Developing and less developed countries are welcoming foreign banks entry into their domestic banking sector with the main objective for emerging their domestic banking sector development toward a greater banking sector. This is because foreign banks entry allows external capital to flow into domestic banking sector, bring along their modern banking skills, new financial innovations, advance banking technology and recent system of banking operations into domestic banks sector (Bonin et al., 1998; Dages et al., 2000).

The presence of foreign banks entry is therefore potentially contributing exposure of innovation and development through fostering efficiency and productivity improvement, as well as market discipline to domestic banks operations and activities (Sengupta, 2007). As such, the main determination of permitting foreign banks entry into domestic banks sector is for the purpose of benefiting those banking advantages that bring along by foreign banks entry.

In emerging market economies, the entry of foreign banks will contribute to the stability of the banking system and function as a stable source of credit, especially during periods of crisis. Mathieson and Roldos (2001) who study whether the presence of foreign banks makes systemic banking crises more or less likely to occur, and whether there is a tendency for foreign banks to ‘cut and run’ during banking crisis periods, pointed out that, in general, foreign banks entry can provide a more stable source of credit because branches and subsidiaries of large international foreign banks entry can draw on their parent institutions (which typically hold more diversified portfolios) for additional funding (Denizer et al., 2007).

In addition, large international foreign banks entry is likely to have better access to global financial markets. Thus the entry of foreign banks can improve the overall stability of the host country’s domestic banking system. Demirgüç-Kunt et al., (1998) has earlier noticed that, over the period of year 1988 to year 1995 and for a large sample of countries, foreign

banks entry was generally associated with a lower incidence of local banking crises.

Furthermore, in a wider potential macro-economic scale, foreign banks entry with great expertise and experience of other financial activities, such as insurance, broker age and portfolio management services, can help nurture the improvement of domestic financial system infrastructure and the financial markets development (Zajc, 2002).Excellent financial system infrastructure and sound financial market development is the essential attraction of foreign direct investment entrance to domestic economy (Hermes and Lensink, 2004). Subsequently, foreign direct investment could diversify the inflow of capital and funding that will increase the amount of fund available for facilitating domestic economic projects (King and Levine, 1993).

Enormous foreign direct investment that is significantly correlated with the excellent financial system infrastructure and sound financial market development will significantly influence the growth of GDP of a certain country. For instance, studies have shown that countries with well-developed and stability of financial institutions tend to experience more rapid rates of real GDP per capita growth (Levine, 1997; Levine and Zervos, 1998). Thus the overall economic success and development of a country is yield from a positive function and excellent development of its financial sector, its banking system stability in particular. Consequently, the entry of foreign banks brings large benefits to host countries' financial systems stability and economies at large (King and Levine, 1993).

5. THE CHALLENGES OF FOREIGN BANKS ENTRY ON DOMESTIC BANKS FINANCIAL PERFORMANCE

Foreign banks entry is however not without risks and challenges that encounter to domestic banks financial performance. Those strong and great reputations of foreign banks entry have created higher unbalance competition especially in domestic banks of less developed and developing countries (DeBrandt and Davis, 2000; Hasan et al., 2000; 2000, Denizer, 2007). The unbalance competition is due to the inability of domestic banks to innovate, imitate and compete with the foreign banks entry advance innovations, technology and system (Berger et al., 2000).

According to Claessens et al., (2001), the unbalanced competition has instigated certain unhealthy impact on the domestic banks financial performance; profitability. As such, according to Clark et al., (2003), as compared to domestic banks, the financial performance of foreign bank entry is more impressive in term of profitability in the domestic banking sector of less developed and developing countries. Consequently, the unbalance competition has reasoned that domestic banks of less developed and developing countries were left behind (Lensink and Hermes, 2004).

Thus, though normally competition from foreign banks entry can persuade domestic banks to become more efficient and achieving excellent performance, but unbalance competition can cause domestic banks from less develop and developing countries that are incompetent with the competitiveness of foreign banks entry are defeated in the competition and are left behind.

Furthermore, according to Calessen et al., (1998), foreign banks entry does practice 'cherry picked' at the domestic economic sector where foreign banks entry is more concentrate on domestic blue-chipped profitable business organizations and tend to be less sensitive to those

of less profitable business organizations. Hence, those domestic less profitable business organizations are left behind for domestic banks. In addition, according to Detragiache & Gupta (2006), foreign banks entry also chooses of low risk firms of domestic economic sector, and has left firms of riskier sectors of the domestic economy to domestic banks. As a result, domestic banks serve the domestic markets riskier sectors businesses organizations.

Subsequently, domestic banks have to compete with foreign banks entry for blue-chipped creditworthy domestic clients and struggle for attaining low risk firms of domestic economic sector (Dages et al., 2000). As such, domestic banks have to take on greater cost by paying higher interest rate on deposits to attract domestic high net worth clients and low risk firms of domestic economic sector to compete with foreign banks entry. As a result, domestic bank spays higher interest rates on deposits but cannot charge higher interest rates on loans. Moreover, foreign banks entry also reduces and decrease market share of domestic banking sector. Thus, foreign banks entry may apparently decrease profits, net interest income and non-interest income of domestic banks (Kalluru and Bhat, 2009).

Foreign banks entry excellent financial performance is because foreign banks entry has generally operated based on a target market, focused on high value corporate clients as against the mass consumer and corporate customers by the domestic banks (Okuda and Suvade, 2007). Other factors that contributing to the better financial performance of foreign banks entry include their global network, accessibility to talents and experience in various markets as well as their superior level of information technology. There are therefore significant efficiency and Excellency gaps between foreign banks entry and domestic banks (Uiboipin, 2005).

The efficiency and excellency gaps situation has led to an increase in the operating expenses and decreased of net interest margin of domestic banks which adversely affected the domestic banks financial performance; profitability in terms of profit before tax (Claessens et al., 2001), ROA, non-interest income, and increment of overall overhead expenses of the domestic banks (Detragiache & Gupta, 2006; Isik, 2008; and Derviz & Podpiera, 2008).Thus, it is apparent that foreign banks entry may bring both advantages and disadvantages to domestic banks.

6. FOREIGN BANKS ENTRY AND DOMESTIC BANKS FINANCIAL PERFORMANCE

Studies that expose the implication of foreign banks entry on domestic banks comprises firstly is from microeconomic efficiency viewpoint; the accent is emphasises on the impact of foreign banks entry on domestic banks profitability, liquidity and efficiency (Claessens et al., 2001; DeBrandt and Davis, 2000; Hasan et al., 2000; Berger et al., 2000). Secondly, is from macroeconomic effectiveness point of view; correlating the influence and impact of foreign banks entry particularly as regards to product and services engineering, risk management and financial sector stability on domestic banking sector.

However, generally, the purpose of this study is to is to establish a synthesis on the literature; the theoretical and empirical basis, of foreign banks entry and its impact to the domestic banks of less develop, developing and developed countries financial performance; profits, net interest income and non-interest income, overhead expenses and loan loss provision.

Earlier, Schranz (1993) who studies the potential costs of foreign banks entry to domestic banks, local entrepreneurs, and the government, has suggested that domestic banks may incur costs since domestic banks have to compete with large international banks with better reputation. Berger et al., (2000) find that, under the global advantage hypothesis, the efficient banking institutions in one or a limited number of nations with specific favourable market or regulatory conditions in their home countries, operate more efficiently than domestic banks in other nations. The statement denoted that foreign banks entries are more efficient in performing their banking activities in domestic banking sector as compared to domestic banks.

The findings of study that perform by Claessens et al., (2001) show that foreign banks entry tend to have higher profits than domestic banks in developing countries, while in developed countries foreign banks are less profitable than domestic banks. Their results also indicated that greater foreign bank presence is related to lower profitability, costs and margins among domestic banks in less develop and developing countries. Hermes and Lensink (2004) who further developed the model used by Claessens et al., (2001) indicate that, at lower levels of economic development countries, foreign bank entry is associated with higher costs for its domestic banks. While at higher levels of economic developed countries, foreign bank entry has a less significant effect on its domestic bank profitability.

Levine (2001) who analysed the relationship between financial liberalization and banking efficiency and found that, allowing greater foreign bank presence in the market enhances the efficiency of the domestic banking system, decreases both overhead costs and the profits of banks. Meanwhile, Zajc (2002) who analysed the effects of foreign bank entry on domestic banks in Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia for the period of 1995 to year 2000, find that foreign bank entry is associated with lower non-interest income and increases overhead expenses of domestic banks. Quite often authors have found that there is no statistically significant relationship between net interest margin and foreign banks'share (Zajc, 2002). This indicates that net interest margin is probably related to their factors, for example, overall competition on the market, banks' own market share and money market interest rates. Unite and Sullivan (2003) observed that foreign banks entry is inversely associated with interest rate spreads of domestic banks, but only in case of those banks that are affiliated to a family business group.

Interestingly, the findings of Claessens et al., (2001) are consistent with the earlier Terrell's (1986) and Demirgüç-Kunt and Huizinga (1999), Unite and Sullivan (2001), Zajc (2002), Uiboupin (2004), Clarke et al. (2003), Denizer et al. (2007) and Kalluru and Bhat (2009).

For instance, Unite and Sullivan (2001) analyse the impacts of foreign banks entry in the domestic banking sector of Philippine during the 1990-1998 period. They show that the foreign banks presence is associated with the reduction in profit and interest margin of domestic banks. Zajc (2002) analysed the impacts of foreign banks entry in domestic banking sector of transition countries (Chezk Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia) during the 2001 to year 2007 period. Zajc (2002) finds that the foreign banks entry reduces the profit and non-interest revenues, and simultaneously increases the cost of domestic banks. Uiboupin 2004 analysed the short-term impacts of foreign banks entry on the performance of domestic banks of Central and Eastern European countries. He used the data from 219 banks of ten countries. He showed that the foreign banks entry has a negative impact on domestic banks profitability, incomes from interest-earning assets and non-interest incomes.

While Claessens et al., (2001) pool the information on domestic banks of developed and developing countries in their empirical analysis, Hermes and Lensink (2001) further analysis the findings of Claessens et al., (2001) which specifically using only data from less developed countries from990commercialbanksin48 countries for the period of 1990-1996 to see whether the results presented in the Claessens et al., (2001) is still holding the same findings for this sub sample of countries. Hermes and Lensink (2001) also employ the number of foreign banks to the total number of banks in the host country and the share of foreign banks entry assets to total bank assets of the host country as representing the present of foreign banks entry at the host countries.

The findings of Hermes and Lensink (2001) reveal that foreign bank presence is positively related to net interest rate margins, overhead costs, and loan loss provisions, whereas it creates a negative relationship for profits and non-interest rate income of domestic banks of less developed countries. The findings indicate that the increase of foreign banks entry numbers and assets share have increase the costs and reduces profits of domestic banks in LDCs. In particular, Hermes and Lensink (2001) find that, foreign bank entry has a positive effect on domestic banks of LDC at low levels of foreign banks entry numbers and assets share. At a low levels of foreign banks entry numbers and assets shares in domestic banking markets, the positive effects on profitability, costs and income out weight the negative effects of competition between foreign banks entry and domestic banks.

Nevertheless, according to Hermes and Lensink (2001), foreign banks entry numbers and assets share have a cost, income and profit reducing impact on domestic bank activities only after foreign bank numbers and assets share have reached to a certain minimum level. Because, as foreign banks entry numbers and assets share increase to a certain threshold are reached, the increases competition effect has outweighed the positive effects of profitability, costs and income that possess by domestic banks earlier. The findings of Hermes and Lensink (2001) discover that, the cost and income reducing effects from the increased competition take place after the extent of foreign bank entry has reached a certain minimum level. Subsequently, the unbalance competition has reasoned that domestic banks were left behind.

Furthermore, according to Feldstein (2000), foreign banks entry does practice ‘cherry picked’ at the domestic economic sector where foreign banks entry is more concentrate on domestic profitable businesses organizations and tend to be less sensitive to those of less profitable businesses organization. Hence, those domestic less profitable businesses organizations are left behind for domestic banks. In addition, according to Detragiach & Gupta (2006), foreign banks entry also chooses of low risk firms of domestic economic sector, and has left firms of riskier sectors of the domestic economy to domestic banks. As a result, domestic banks serve the domestic markets riskier sectors businesses organizations.

Hence, domestic banks have to compete with foreign banks entry for blue-chipped credit worthy domestic clients and struggle for attaining low risk firms of domestic economic sector (Chantapong, 2005). As such, domestic banks have to take on greater cost by paying higher interest rate on deposit stoat tract domestic high net worth clients and low risk firms of domestic economic sector to compete with foreign banks entry. As a result, domestic banks pay higher interest rates on deposits but cannot charge higher interest rates on loans. The situations have led to an increase in operating expenses and decreased of net interest margin of domestic banks which adversely affected their financial performance; profitability in terms of ROA, non-interest income, and increment of overall expenses of the domestic banks

(Detragiache & Gupta, 2006; Isik, 2008; and Derviz & Podpiera, 2008).

Using Arellano-Bond dynamic panel estimation technique, Uiboipin (2005) investigates the impact of foreign bank entry market share; represented by the foreign bank entry assets share to total bank assets of a host country on bank performance from ten Central and Eastern European countries over the period year 1995 to year 2001. Uiboipin (2005) finds that, foreign bank entry market share is associated with lower before-tax profits, non-interest income, and average loan interest rate and loan loss provisions of domestic banks. Foreign bank entry tends to increase the overhead costs of local banks in the short-run as foreign bank entry enhances competition on the market.

Uiboipin (2005) further reveals that, in more developed banking market, foreign bank entry is less likely associated with decreasing profits, incomes, overhead costs and loan loss provisions than in less developed banking markets. The results of Uiboipin (2005) shows that domestic banks of developed countries with higher asset share react less to foreign bank entry in terms of non-interest income and loan loss provisions. Domestic banks with higher asset share react less to foreign banks entry because they are either too big to react quickly to market conditions or foreign bank entry is less important for them compared with smaller banks (Uiboipin, 2005).

Moreover, Denizer et al., (2007) who examine the entry of banks from foreign countries in the banking sector of Turkey reflect that, the entry of banks owned by foreigners negatively affect the domestic banking industry of Turkey. The results of Denizer et al., (2007) discover that, the domestic banks overhead expenses, net interest margin are decreased and their ROA are declined. According to Denizer et al., (2007), the entry of banks owned by foreigners resulted in competition with domestic banks, which led to an increase in operating expenses and a decrease in ROA of domestic banks. Those results support the idea that the foreign banks entry put pressure on domestic banks in Turkey in terms of competitiveness. As such, the domestic banks efficiency is negatively affected from the competition.

Kalluruand Bhat (2009) who conduct study on the effect of foreign banks entry on Indian banks using financial information from year 2001 to year 2005, year 2003 to year 2007and year 1996 to year 2007 also conclude that foreign banks entry were relatively more efficient as compared to Indian local banks. They agreed that the entry of banks owned by foreigners resulted in a reduction in net interest income caused by an increase in operating costs and bad loans made by the domestic-owned banks. Their result observed that foreign owned banks ‘cherry picked’ the blue-chipped businesses and left credit unworthy firms and riskier sectors of the economy to domestic owned banks.

7. CONCLUSION

Research results show that foreign banks entry is beneficial to domestic banks of less developed and developing countries since the introduction of efficient banking management practices, latest banking technologies and latest financial innovations to domestic banks. Management of domestic banks could learn and adopt those advantages to improve their banking operations. Foreign banks entry has initiate domestic banks to become more efficient in their banking business operations. Foreign banks entry causes positive impact to domestic banks financial performance.

Nevertheless, strong and great reputations of foreign banks entry have created unbalance competition between foreign banks entry and domestic banks of less develop and developing

countries due to the inability of domestic banks to innovate imitate and compete with the foreign banks entry advance innovations, technology and system.As such, foreign banks entry impose negative impacts on domestic banks financial performance of developing and less develop countries, where domestic banks were left behind. Hence, foreign banks entryis said to bring negative impact to domestic banks financial performance.

Meanwhile, foreign banks entry has less significant impact on domestic banks financial performance of developed countries since the potential of domestic banks of developed country to learn on banking innovations, technology and system from foreign banks entry is not high. Because, the banking innovations, technology and system of domestic banks of developed countries are more advance than the one own by foreign banks entry. Thus, foreign banks entry brings less positive or negative impact to domestic banks financial performance of developed countries. Foreign banks entry is associated less with decreasing or increasing incomes, overhead cost and loan loss provisions of domestic banks of developed countries than in less developed or developing countries.

Foreign banks entry as a group possessed a strong presence that has generally been a head of domestic banks in terms of financial performance as reflected by their higher return on equity and return on asset. Foreign banks entry has become key players with a significant dominating on the domestic banking sector of less develop and developing countries but not for developed countries. The results from those above studies are mixed, thus it provides an essential gap as motivation to further future study concerning the impact of foreign banks entry on the domestic banks financial performance from the different time frames and countries perspectives.

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