

Are foreign banks welcome?

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In the latest Budget presented to Parliament, the Indian finance minister, Pranab Mukherjee, signalled a renewal of the policy of banking sector liberalisation when he noted that the government was considering granting new bank licences to the private sector as part of the broader financial sector reforms. However, whether this policy is limited to only domestic participants or will also be broadened to foreign bank entry isn't quite clear.

Over the last decade, many emerging Asian economies have been liberalising their financial sectors, including opening up their banking systems to foreign competition. An immediate motivation for the adoption of this policy in countries like Indonesia, Korea and Thailand was the possible infusion of much-needed foreign funds that could help recapitalise their banks 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 always result from domestic competition.

What has been the impact of these regulatory changes on the banking sectors in Asia? To gauge this, it is useful to assess the extent of market share of foreign banks in terms of assets and liabilities. The accompanying table 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. The levels of foreign bank penetration have sharply increased in Indonesia and Korea and to a lesser extent in Thailand and the Philippines, especially in terms of the foreign banks' 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% share of total banking assets at the end of 2007—though up from almost zero in 1997.

India and Malaysia are interesting cases, though. There was no substantial change in the market share of foreign bank assets and deposits pre- and post-crisis in both these countries. In fact the share of deposits of the foreign banks actually declined in both, although marginally. This appears to be largely because of a rapid rise in the presence of private domestic commercial banks that drew their market share from national banks as well as foreign banks.

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 private domestic banks. 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 among the Indian branches of foreign banks, there were also closures of some foreign banks in this period. Domestic consolidations and privatisations were preferred rather than allowing foreign bank entry per se. Thus, the share of foreign bank assets in the total commercial banking assets stood at nearly 8% in 2007, almost on par with the levels during the 1997 financial crisis, while that of deposits declined from about 7% during 1997 to around 5.8% in 2008. As against this, the significance of private sector banks has been growing steadily since 1997 and they accounted for nearly 22% of the banking assets at the end of 2007—up from about 10% in 1997. The same trend is seen in deposits—the share of deposits held by private banks expanded dramatically post-crisis from about 8% to 20% in 2007.

Overall, therefore, the process of bank deregulation in India since the mid-1990s has largely involved the entry of domestic as opposed to foreign players. And even this policy was effectively on a hiatus since 2004 with no new licences being granted in the last 6-7 years, despite strong interest by both local industrial houses and foreign financial institutions keen to enter the Indian market.

So, even while the latest budget appears to signal the restart of the bank deregulation process in India, what is unclear is whether there will be any scope for new foreign entrants in the market. 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 non-performing loan 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 that could act as a private lender of last resort during a period of financial stress.

As against this, there is a growing concern that foreign banks might be a source of instability and contagion rather than of stability. This appears to have been the case in the recent global financial crisis which hit the Eastern European financial system

Countries	Share of banking assets (%)		Share of banking deposits (%)	
	1997	2007-08	1997	2007-08
Indonesia	5.8	47 (2008)	4.9	6.1 (2002)
Malaysia	21.6	23 (2008)	21.1	20.8 (2008)
Thailand	7.1	12.6 (2008)	2.9	7.8 (2008)
Philippines	8.5	13.2 (2007)	NA	NA
Korea	2.2	15.7 (2008)	3.8	10 (2002)
China	0.1	2.3 (2007)	NA	NA
India	7.9	8.4 (2008)	7	5.8 (2008)

Note: A bank is defined as foreign if it includes over 50% of shares; Figures in parentheses denote the latest available year for that country; NA-Not Available

much harder than the relatively more closed and regulated Asian financial system. Has greater banking sector internationalisation made some economies more prone to financial instability, and are certain types of financial openness preferable to others? These are clearly hot-button issues with no definite policy conclusions as of yet. Much more careful research is needed in these areas before definitive policy conclusions can be drawn.

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