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# The Role of Foreign Banks in Emerging Banking Sector in the Developing Countries like Pakistan

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**Abstract**
Banking sector plays a significant role in the development of a country, that's why the financial advisors of the country place a high priority on the growth of the banking sector. Efficient banking system gives direction to the basic policies regarding micro and macro level stability and instability. There is a huge body of literature which confirms that banking system is an important indicator of economic growth. Even some early literature has found an active correlation between financial development and economic growth. Some recent research literature has also concluded that financial development increases the economic growth. Majority of governments are working towards the opening up of their banking system for foreign banks to increase competition, which in turn reduces the administrative costs, lowering banks rate of return and decreasing net interest margins. Researchers, academics and policy makers are studying the impacts of foreign bank entry in the domestic markets. Some researchers have found that foreign bank entry has different impacts in different economies and it is hinged upon the economic development level.
**Keywords:** Profitability Efficiency, Domestic Banks, Foreign Banks

## 1. INTRODUCTION

The foreign banks played a significant role in the development of banking sector in the developing countries. It has been observed that foreign banks' presence have positive effect on efficiency of banks on one hand and contributes to healthy competition in the domestic banking sector of the countries on the other hand. However, it is not obvious that how much impact of foreign ownership have on the strength of banking sector. To some extent it has a stabilizing impact in the developing countries for the following reasons. First, foreign banks are less sensitive to home country conditions. Secondly, foreign banks have easy access to international markets in case of financial difficulties as parent banks act as a lender of last resort. Third, the cost of restructuring the banks decreased due to capital influx by foreign investors. Fourth, foreign banks transferred with them know how and expertise in managing risk and traditions of corporate governance for efficient working of banking sector (Bonin et al., 2005).

On the other side, the foreign banks can also add to the decline of banking sector due to change in business conditions, strength and policies of the parent banks as well as home country. The foreign banks are always in search of capturing finest set of customers and leaving riskier borrowers to their domestic counterpart which may become a cause of their poor performance.

The basic aim of this research was to compare the profitability and efficiency of domestic and foreign banks which are operating in the Pakistan's banking sector between the years 2006-2010. While reviewing the literature, it was found that no other study exists regarding the comparison of foreign and domestic banks in Pakistan. This study tried to bring out the similarities and differences in the domain of profitability and efficiency of domestic and foreign banks. Therefore, this study tried to fill a gap in the literature and becomes quite important.

## 2. PROFITABILITY AND EFFICIENCY

Wahid and Rehman (2009) have researched on the efficiency of foreign banks working in Pakistan. They tried to find out the reality about the myth that foreign banks were more efficient and profitable than domestic banks. They found that foreign banks were better than the local banks (83-499-1-PB). He also found that 40% of the foreign banks were running into deficit, however the capital efficiency of these banks was much better than domestic banks.

Sufian (2009), in his research conducted in Malaysia, analyzed the factors, which influences the bank's profitability especially foreign and domestic covering the period 2000-2004. He found that there was a negative relationship between credit risk and loan concentrated for Malaysian banks. It means that higher the credit risks, the more its exposure to loan payment which will result in low profitability. He also found that capital size, income from non-interest sources and operating expenses has a positive effect on bank's profitability. Moreover, a bank having more capital will have higher profitability.

His results show also, although negative relationship between profitability and economic growth, high inflation rate affect them positively. A research conducted by Flamini, McDonald and Schumacher (2009) in the Sub-Saharan Africa (SSA) who analyzed the determinants of profitability in 389 banks in 41 countries. The results show that foreign and private banks were doing better than public sector and local banks in realm of profitability. They also found a positive relationship between banks size, activity diversification & private ownership and profitability and negative impact of credit risk and macroeconomic variable on bank profitability".

According to Ali and Akhtar (2011), profitability of banks can be increased through well-organized asset management and economic growth. They further argued that high credit risk of advances result in lower level of profitability of banks. GDP has also positive effect on the profitability of banks as micro variable. As micro indicators, profitability of banks is positively affected by operating efficiency, size of bank and profitability is negatively affected by credit risk.

San, Theng and heng (2011) used DEA to examine and compared the efficiency of domestic and foreign banks working in Malaysia. Data included 12 foreign and 9 domestic banks between the years 2002-2009. The result showed the domestic banks to be more efficient and have more management competency than foreign banks.

The efficiency of foreign banks when compared to domestic banks is different according to the types of foreign banks and types of host markets. Foreign banks usually perform better than domestic banks due to their ownership advantages (Claessens, 2001, Pasiouras and Kosmidou, 2007, Havrylchyk and Jurzyk, 2011). However in developed countries, foreign don't perform better because they face competition and experience a decrease in profit (Nolle, 1996, Sturm and William, 2008). Greenfield banks which was 100% foreign owned were more efficient and holding a lower degree of risk than other types of foreign banks in Latin America, Asia and Eastern and Central Europe between 1996 and 2003 (Wu, Luca & Jeon, 2011).

In Vietnam, domestic banks were more efficient than foreign banks due to the benefit of local market and its knowledge and longevity (Nahm & Vu, 2008). Among these domestic banks, the state owned banks were more efficient because of government support and their long existence (Truong, 2011). With the passage of time, when the market opens up freely to other enterprises, the dominant role of domestic banks will be replaced by foreign owned banks and private banks.

## 3. DISCUSSIONS

It has been found that the entry of foreign banks in the financial sector of Pakistan has a positive and healthy effect on the efficiency and working of domestic banks in Pakistan (Iimi, 2004).

During 1980s, it was felt that credit and monetary policies followed in the past decades have adversely affected the efficiency and growth of the financial sector and had given way to depressed financial system. It was in this scenario that at the start of 1990, a reform program was started to minimize the market segmentation, inspire competition and switch over to efficient credit and monetary mechanism. However, this process was accelerated in 1997, when a key reforms were introduced to restructure banks and DFIs, institutional strengthening and improve regulatory framework.

Researchers have extensively investigated the benefits and costs of operations of foreign banks in the domestic financial sector. The World Bank (2002) has summarized the benefits as follows:

- The entry of foreign bank has positive impact on the efficiency of the domestic banking sector. Enhanced competition increases profits and reduces costs.
- Credits' allocation to the private sector may be improved since it is expected the evaluation and pricing of credit risks to be more sophisticated. This can help foster higher growth.
- The entry of foreign banks also helps in building the domestic banks' legal and supervisory framework and increases the overall transparency.
- Foreign banks provide stable credit sources just because they can get additional funding from their parent banks which have easier access to the international markets. Thus domestic shocks have less impact on the financial markets.
- Foreign banks may reduce the costs associated with recapitalizing and restructuring banks in the post-crisis period.

The costs associated with the entry of foreign bank in the domestic financial sector are specified as follows:

- If a decrease occurs in the franchise value of domestic banks with the entry of foreign bank, they may have reason to take greater risks.
- Foreign banks have more advanced products and services; they can attract the profitable portion of domestic markets. Thus domestic banks are left with no option to serve the riskier sectors.
- Access to credits, due to the presence of foreign bank, may be harmed for some sectors of the economy.
- If foreign banks pull out of the host country due to some problems, it may increase financial instability
- Foreign banks have difference in business focusing and priorities, so their lending pattern has the tendency to ignore the domestic priorities.

Claessens, Demirguc-Kunt, and Huizinga (1998) examine the effects of foreign bank entry on the domestic banking sector. They show that in developing countries foreign banks tend to have greater profits, higher interest margins, and higher tax payments compared to domestic banks. But the opposite is true in developed countries. Another interesting conclusion is that both profitability and overhead expenses of domestic banks fall with foreign bank entry. Demirguc-Kunt, Levine, and Min (1998) show that foreign bank participation lowers the possibility that a country will experience a banking crisis. They indicate that the presence of foreign banks lowers overhead costs and profits of domestic banks. Foreign banks also increase overall economic growth by raising the efficiency of domestic banks.

We ponder on other cost of foreign bank entry which is observed by Agenor (2001). As foreign investors could not have familiarity with the competitive and emerging markets, they may promptly retreat and massively confronted with the first difficulty. This can lead to severe crises in the local financial markets.

There are also studies focusing on country-level experiences. Denizer (2000) investigates foreign bank entry in Turkey's banking sector. He shows that the net interest margin, overhead expenses, and returns on assets are related to foreign ownership. He also indicates that foreign bank entry has a strong competitive effect on the banking sector. It lowers the return on assets and overhead expenses. Hasan and Marton (2000) investigate the Hungarian banking sector during the transitional process. They conclude that banks with higher foreign bank ownership involvement are associated with higher efficiency. Goldberg, Dages, and Kinney (2000) study the role of foreign banks in determining the health of domestic financial systems in Argentina and Mexico.

The health of banks, and not their ownership, is the critical determinant in the growth, volatility, and cyclicality of bank credits. But diversity in ownership tends to contribute to greater stability of credit in times of crisis and domestic financial system weakness. Peria and Mody (2004), analyzing a group of Latin American cases in a pooled time-series cross-sectional framework, find that foreign banks charge lower interest rate spreads than domestically-owned banks. They also find that foreign bank entry is associated with an overall increase in administrative efficiency and a decrease in interest spreads, suggesting that foreign entry spurred competition. Unite and Sullivan (2003) find that foreign entry was associated with declines in interest rate spreads, overhead expenses, and profits in the Philippines, but that the effect was confined to domestic banks that had been tied to business groups. Kasekende and Sebudde (2002) report that foreign banks in Uganda have better internal control mechanisms than domestic banks in terms of judging the quality of borrowers.

## 4. CONCLUSION

The foreign banks have better Non-IITA. But the interpretation of this ratio is subject to some controversy. Some analysts view a high number as well, since it shows that the bank is not dependent on its lending activities to generate a profit. However others take the opposite view and view a high number as indicating that the bank is dependent on unstable revenues that are not predictable for its profitability which leads to the conclusion that foreign banks are more dependent on unpredictable revenues such as Non-IITA and ROE. In view of the above, we can easily conclude that domestic banks in Pakistan are more profitable than foreign controlled ones as far as the volume of the profit is concerned which is reflected in their earnings per share but the foreign controlled commercial banks in Pakistan, as a whole are more capital efficient as compared to the local controlled commercial banks subject to few exceptions.

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