

# The Profitability and Efficiency of Foreign and Domestic Banks: A Mode of Economic Development

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## Abstract

For developing countries it is necessary to have a sound banking system in the growth framework since banking system has tremendous influence on the growth in the early stages. Pakistan initiated its banking reforms in the 1990s and allowed many foreign banks to open their branches in the different cities. Foreign banks entry in the financial markets of Pakistan had a positive and healthy influence on the performance and profitability of the domestic banking sector. Some researchers have compared the performance of domestic and foreign banks from 1988-1995 in the context of developed and developing countries. In developing countries, not adequate research has been conducted but a lot has been written about the effect of financial reforms conducted in various capacities.

**Keywords:** Profitability Efficiency, Domestic Banks, Foreign Banks, Economic Development

## 1. INTRODUCTION

Banking sector is considered as one of the key sectors that plays a very crucial role in economic development and fiscal stability (Ryu, Piao & Nam, 2012). A country can't show a sustainable growth and stability if it has an unhealthy banking sector. According to Karacaoglan (2011), foreign banks are playing major role in Turkey and other developing countries. While Demireli (2010) says that performance measurement is very necessary to assess the banking sector's success in terms of international and national context.

The development of financial services and restructuring of domestic financial sector are both interlinked processes meant for facilitating economic growth through efficient and aggressive financial system. Due to these factors, the foreign banks' presence increased in south East Asia from about 1.6 % to 6 % during 1990s. In Latin America foreign bank control of domestic financial market rose from 7.5 per cent to 25 % during the same period. The share of foreign banks in domestic financial sector in Eastern Europe was dramatically increased from 8 percent to 52 percent in 1990s (IMF, 2000).

A study was conducted to compare the financial performance of public, foreign and private banks working in Nepal from 2005-2011. This study found that effectiveness of foreign and domestic is better than the state owned banks (Jha & Hui, 2012). Foreign and domestic banks were found to have equal efficiencies according to the study. Similarly, a same study was conducted in Ghana to compare the domestic and foreign banks between the years 2005-2011. They compared the banks in terms of size, profitability, asset quality, liquidity and capital adequacy. Foreign banks showed to have better size, liquidity, asset quality and capital adequacy while domestic banks showed a higher return on equities and assets when these were compared with foreign banks (Mathew & Esther, 2012).

Some researchers have studied the financial performance of banks working in the developing and developed countries. They studied the data from 1988-1995 and found that the performance of foreign banks to be higher than domestic one (Kunt & Huizinga, 1999). Similarly Chantapong (2003) compared the foreign and domestic banks in terms of financial performance in Thailand between the years 1995-2000. This study found domestic banks to be less profitable than the foreign banks.

## 2. THE BANKING SECTOR

Banking sector of Pakistan saw many phases of reforms in accordance with the needs of time. The first phase of reforms started in the late 1980s. In this stage, a policy to liberalize the state owned banks took place. Some state owned banks like ABL (Allied Bank Limited) and MCB (Muslim Commercial Bank) were partially privatized. Another hallmark of this stage was the granting of full autonomy of full autonomy to State Bank of Pakistan, national regulatory bank of Pakistan. Previously it was working under the umbrella of Ministry of Finance. Later on, it was independent of all constraints. It is significant to note here that during this tenure of liberalization policy initiation, all these steps were taken by the government to solely focus on increasing the efficiency in the banking sector of Pakistan to ensure the competition base market system.

An environment ridden with competition always brings within it efficient methods of operations to maximize profits in Domestic hands. The state is less concerned with profit and more with power. It resulted into

inefficiency of the financial sector as this section will be perused in the literature review. Its priorities are based on power- structure not on market-oriented stages of economic growth. In this regard, some of the considerable effort had been taken such as an increase in asset quality, improve the managerial structure, reducing control on credits and leading the market environment (Rehman & Roaf, 2010).

Second stage of reformation of banking sector took place in 1990s; the main intention was to totally finalize the privatization and liberalization policy. In this phase:

- Firstly, the capital structure of the banks was modified.
- Secondly, partially privatized banks were fully privatized.
- Thirdly, the ownership of the State Bank of Pakistan was decreased by 93% to 34% (SBP).

Some beneficial outcomes were noticed in the second phase of reformation, which are as under:

- At least ten private banks were given licenses to enter into the market in 1991.
- The residual share value was covered by 25 foreign banks including some of international banks.
- Banks were given detailed instruction regarding the credit policy for specific sectors, expansion of the branches and also the given administration of interest rates.
- At the end of 2010, the number of banks was 46, which includes 33 private banks and 13 as foreign bank (SBP).

The net-effect of all of these reformative phases of the financial sector came in early 2000 and within the short span of 5 years in the banking industry in Pakistan was of worth 4 trillion rupees in 2005. The total share of the banking sector assets to GDP ratio increased from 47.2% to 55.6% during 2000 to 2005. These facts show the tectonic, but hopeful changes in Pakistan GDP with compare to later years of 1990.

All these achievements were due to the liberalization, privatization and transformation of banking sectors from public to private sector. Another interesting factor was the return on the banking asset which was uplifted up to 2.6% and return on equity was in 25.4%. According to the World Bank, Pakistani banking sector has been ranked second amongst the South Asian countries. The profitability and the capital structure were improved and it reached at exorbitant levels of 11.91%. Inefficient loan was reduced significantly to 2.1% which was almost close to international standards. The payback ratio of loan is now at 70% (Rehman & Roaf, 2010).

### 3. DISCUSSIONS

Nimalathasa (2008) compared the financial performances of foreign, domestic, state owned and private banks working in Bangladesh from 1999-2006. He found the foreign banks should have higher performance than domestic banks with respect to profitability, interest income and liquidity.

Researchers have concluded that banks profitability is function of many factors i.e. internal and external. Internal factors are bank specific and external factors are macro-economic and industry specific. Bank specific indicators are capital risk, profitability, asset quality, growth in bank assets and operational efficiency. Industry specific indicators are bank concentration index, ownership and bank size; while macroeconomic factors are interest rate, inflation, interest rate spread, growth in GDP and per-capita income (Millon and Tehania (1992), Mercia, *et al.* (2002), Toddard, *et al.* (2004), Guru *et al.*(2001) and Panayiotis *et al.*(2006).

Varadi *et al.* (2006) have examined the efficiency of banks and used four indicators productivity, probability, financial management and asset quality for private, public and foreign banks for period of 1999-2003. According to results, Public banks were more efficient while private banks were highly inefficient, but foreign banks were in a better position as compared to private banks in terms of efficiency.

Guru and Staunton (2000) conducted research about the commercial banks in Malaysia to find out the determinants of profitability and concluded that managing the market interest rate and expenses of banks plays an important role to determine the profitability of commercial banks. They concluded that banks must increase the current account deposits on which no interest is payable in order to increase profits and reduce expenses. Moreover, banks must be vigilant and careful while advancing loans in order to reduce risk indicators.

### 4. CONCLUSION

The findings of this research are mixed. In some cases domestic banks outperformed the foreign banks while in other cases foreign banks performance was above the mark. However, the overall picture shows that foreign banks seems to perform better as compared to the domestic banks as a whole, due to their efficient risk management and high investment in technology. Although, domestic banks inherited a high ratio of assets and longevity than foreign banks, domestic banks face the highest loan loss provision ratio.

Foreign banks have better ROE than domestic ones, which shows the better capability, efficiency and profitability of foreign banks. But on the other hand a good level of ROE may either reflect a good level of profitability or more limited equity capital. So we can't say for sure that foreign banks are more efficient. Whereas domestic banks have higher return in ROA which shows that domestic banks have more efficient management in utilizing its asset base.

## 5. SUGGESTIONS

This research has enabled the researcher to put forward some useful suggestions for future research:

1. This study used six performance indicators to evaluate and compare the profitability and efficiency of domestic and foreign banks. By taking some more indicators, a clear picture may emerge regarding the profitability of these banks.
2. This research may also be extended to other countries to study the profitability of foreign banks in other countries of the region. A research to study the performance of foreign banks in Pakistan compared to foreign banks in Muslim countries in particular and non-Muslim countries in general can be carried out.
3. Another research to compare the performance of Islamic banks with foreign banks in Pakistan may also be conducted.
4. For future studies, with the passage of time when there will more foreign banks to study and longer time period, a similar study would generate better insight on the issue of performance comparison.
5. In this research, bank specific variables have been used to determine the efficiency of banks. Future researchers are advised to use macro-environment variables such as bank type, ownership, regulatory and geographical region.
6. In this research, 5 years period was used. Future research may include longer period to determine the more accurate measure of efficiency and reliability.

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