

The major integration features of banking system

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Abstract. The internationalization of the banking sector in developing countries brings both significant benefits and challenges. Foreign banks promote competition, efficiency and financial inclusion, which accelerates the integration of local banking systems into the global economy. However, the arrival of large international players may increase risks and force local banks to make significant changes. Studies show that the influence of foreign banks is ambiguous and depends on the level of economic development of the country. When assessing the effects of globalization, it is important to consider the differences between developed and developing countries. In periods of economic crisis, foreign banks can play a stabilizing role, but they can also import shocks from their own countries. To maximize benefits and minimize risks, it is necessary to develop a strategy that ensures a balanced presence of foreign banks, supports competition and innovation, but does not allow excessive concentration of bank capital. In this context, the internationalization of financial services becomes an important tool for strengthening and liberalizing the financial systems of developing countries, opening new opportunities for their economic growth and sustainable development. Since the collapse of the Bretton Woods system and the beginning of the era of financial liberalization, one of the most important manifestations of the process of integration of the banking sector into the world economy has been the expansion of foreign banking capital into foreign markets. Financial sector liberalization is intended to provide equal opportunities for financial institutions to access the international market or reduce restrictions from local regulators. Liberalization of the banking industry is one of the most important financial sector liberalization programs.

Keywords: Internationalization, foreign banks, developing countries, banking system, competition, financial services, economic growth, financial stability, financial integration.

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1 Introduction

In recent decades, the banking sector of large parts of developing economies has become more international. This internationalization of banks occurred, among other things, due to the influx of foreign banking capital, including through the creation of foreign branches. A foreign bank's entry into a new market may bring both benefits and costs to the host country. On the one hand, the entry of a foreign bank increases competition, which, in turn, can increase the efficiency of the banking system of the host country. Moreover, foreign banks can contribute to improving the availability and quality of financial services. There are plenty of examples of this too [1-2].

On the other hand, local banks have to compete with large international banks. To become competitive, domestic banks have to invest and adapt their business model. But the other side of the coin here is the possible increased risk.

Researchers, experts, and practitioners differentiate the consequences for developed and developing countries, since the arrival of foreign banks affects these groups of countries differently. This is due to the fact that market conditions for foreign banks may differ. For example, in developing countries, state-owned banks, whose influence was discussed in the previous paragraph, may still play a more important role.

Of particular importance to the topic of our dissertation is the phenomenon when foreign banks can expand the host country's access to international capital markets. In relation to developing countries, this aspect is directly related to the integration of the banking systems of these countries into the world economy [3-4].

2 Methods

A whole series of crises in emerging and developing economies (EMDE), from the 1990s to the present day, first affecting Latin America and Asia, and then the countries of Central and Eastern Europe (CEE), has served as a serious incentive for crisis-hit countries to open their domestic markets to foreign banks, mainly to recapitalize their damaged banking systems.

Despite differences in the degree and scope of their participation in different regions and countries, the presence of foreign banks in EMDE has grown significantly across the board. One of the frequently used criteria for measuring the extent of the presence of foreign banks in a country is to assess their share of assets in the national banking system. The growth of this indicator in EMDE was particularly rapid (from 22% to 44%) in the period from 1995 to 2009, when this share doubled (Fig. 8).

It is noted that back in the 1980s, foreign banks were mainly expanding in Asia through their branches or representative offices. And there is an explanation for this, namely: it is favorable for foreign banks to enter the market of developing countries through branches because:

- a) head offices have greater flexibility to control operations;
- b) branches are officially dependent on the jurisdiction of the home country.

The arrival of foreign banks in CEE was caused, at least in the early years, by privatization during the transition of the countries of this region from a centralized economy to a market economy, including as part of efforts to achieve accession to the EU.

The admission of foreign banks to the host country's economy can bring a number of benefits. Gopalan in his study originally presented his findings based on the results of a review of the literature on the entry of foreign banks into the market and the consequences for host economies (Fig. 9).

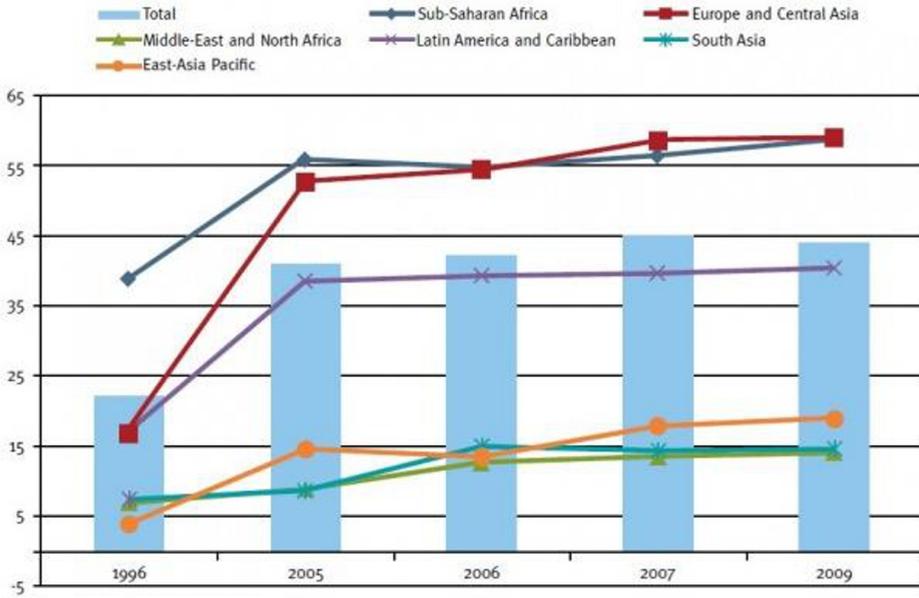


Fig. 8. Dynamics of entrance of foreign banks.

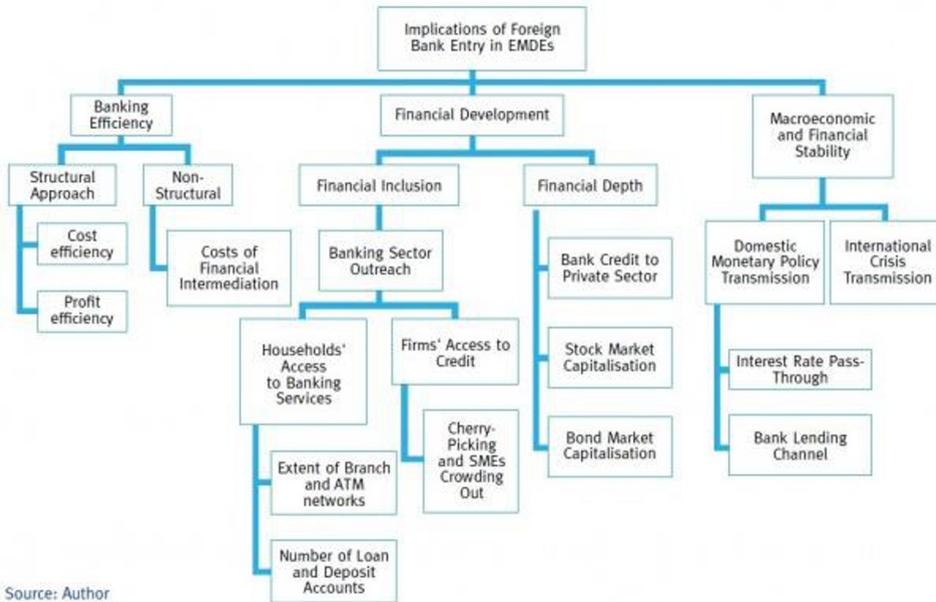


Fig. 9. Multidimensional consequences of the entry of foreign banks.

Several studies have documented improvements in the efficiency of the domestic banking system in host countries, particularly in the context of EMDEs. A large body of research shows how foreign banks achieve efficiency gains by:

- Helping to reduce the cost structure;
- Improving operational efficiency;
- Introducing and applying new technologies and banking products.

In this regard, foreign banks can improve the quality of human capital in the domestic banking system by recruiting highly qualified personnel to work in the local host branch and by disseminating knowledge among local employees, which in turn can benefit customers through access to new financial services. Not only do foreign banks tend to operate with lower overheads and charge lower spreads than domestic banks, they also promote banking competition by pressuring other banks to reduce their costs and spreads, leading to an overall improvement in the efficiency of the banking system [5].

In addition to the promise of increased efficiency, which remains the most frequently cited rationale for allowing foreign banks, the literature also widely points to how foreign banks contribute to the development of financial and money markets in the host economy, which ultimately leads to favorable economic growth. Foreign banks could contribute to financial deepening by expanding bank lending to the private sector, increasing liquidity in the domestic equity market, or facilitating a market for large-cap bonds. Overall, research has found evidence that foreign banks help reduce the costs of financial intermediation, which leads to increased availability of credit and accelerated financial development in the host country.

However, there are also studies that suggest that in EMDEs, foreign banks may reduce financial depth. However, they also note that it is important to take into account differences in economic development across countries before concluding that there is a negative relationship between foreign banks and financial depth. In their study, Gopalan examined the relationship between foreign bank presence and financial deepening for 57 EMDEs over the period 1995 - 2009. They found that foreign banks tend to have a direct positive effect on further financial deepening. Also, the marginal effects of foreign bank entry decrease as income levels rise. In other words, the impact of foreign bank entry tends to decrease as a country reaches a higher level of economic development. The second aspect concerns how foreign banks expand the availability of financial services to households and firms, which contributes to financial inclusion in the economy. A study of the relationship between foreign bank entry and financial inclusion in 52 countries over the period 2004–2009 found that foreign banks have a significant direct positive effect on financial inclusion, although the positive effect is significantly reduced when we control for levels of bank concentration in the economy. To be fair, there are concerns that, given the tendency of foreign banks to serve a smaller segment of the population, their entry into emerging markets may have a negative impact on the outreach of the EMDE banking sector [6].

Another aspect of foreign capital participation in the banking sector is the impact on macroeconomic volatility and financial stability in the host country. In theory, foreign banks have the ability to raise the necessary funds from their head offices in the parent country. This means that foreign banks could be a vital source of stability during periods of stress in the host economy. But they can also serve as a potential transmission mechanism for external shocks that increase instability in the host country. In this regard, two key aspects of foreign banks' lending behavior are highlighted. The first is whether foreign banks act as stabilizing factors in terms of credit supply during crisis shocks or, on the contrary, as transmitters of shocks.

The second is how foreign banks influence the transmission mechanism of monetary policy conducted in the host country in the face of shocks to the latter.

On the one hand, it is noted that due to their better access to alternative business opportunities than domestic banks, foreign banks can be somewhat “fickle lenders”. This can lead to them importing shocks from their home countries, destabilizing the host country’s banking systems. On the other hand, foreign banks, having diversified sources of liquidity, can serve as a buffer against negative shocks. This is precisely what happened in a number of Asian and Latin American countries, where, after crises, several foreign banks contributed to a more rapid recapitalization of local banking systems. The literature on the effects of

foreign bank lending during the recent global financial crisis (2007–2008) is unanimous in finding that, compared with domestic banks, foreign banks appear to contribute to instability by rapidly reducing their lending. However, an important difference between the global crisis and previous crises is that the former was centered in advanced economies, whereas previous crises were centered in emerging market economies. This has led to a greater focus on the impact of parent funding shocks on affiliate lending.

Overall, most studies find that foreign banks have been more consistent in their lending during many emerging market crises, and that the impact of foreign banks on financial stability has generally been positive. In addition, traditional foreign banks have been more willing to do so than foreign banks that have otherwise entered emerging markets, such as through mergers and acquisitions. This reveals the importance for financial stability of the method of entry of foreign capital into the banking sector of the host economy.

Another important aspect of the influence of foreign bank capital on the qualitative aspects of the host country's banking sector, especially in crisis situations, is the influence of foreign banks on the transmission of domestic monetary policy. An important component of the transmission mechanism in EMDEs is the transmission of interest rates, especially for those developing countries that have switched to flexible exchange rate regimes. As a result, interest rates immediately became an important instrument of macroeconomic regulation in these countries. One study, based on data from 57 emerging and developing economies for 1995-2009, analyzes and assesses the influence of foreign bank capital on changes in interest rates in these countries. It turns out that the presence of foreign banks contributes to changes in interest rates only in countries with a sufficient degree of such presence. Research has also shown that with the introduction of controls on bank concentration, the change in interest rates weakens. This is an important conclusion in favor of the need for serious attention to how foreign banks influence the market structure through increased banking competition. A very interesting aspect of the entry of foreign capital into the banking sector of developing countries is revealed in the study of the Centre for Economic Policy Research of the Bank of England. It is noted that, driven by globalization and increased financial integration, many foreign banks have entered developing countries. And if at first these were banks from high-income countries, then they were followed by banks from developing countries. A study of the differences and similarities between foreign banks in developed and developing countries revealed that the importance of foreign banks in developing countries is much higher in low-income countries (in terms of the number of banks and in terms of assets), and their business is heavily concentrated at the regional level. Foreign banks from developing countries are more likely to invest in small developing countries with weak institutions, where banks from high-income countries are reluctant to go. This is presumably explained by the fact that banks in developing countries have a competitive advantage in countries with a weak institutional climate. In addition, foreign banks in developing countries have higher interest margins and are less profitable than foreign banks from high-income countries.

Most foreign banks from developed countries in developing countries usually focus on financing corporations originating from their own parent country. Foreign banks actually accompany their clients, which are often large international, including transnational companies. Dealing with the same banks, companies feel comfortable.

At the same time, the likelihood that foreign banks from developed countries will finance small and even medium-sized businesses of the host country is extremely small. It is known that servicing SMEs requires relatively more labor costs, and this is too expensive for foreign banks from developed countries, since the salaries of their personnel are relatively higher than in the banks of the host country.

Based on the above, researchers, experts, and practitioners highlight several key effects of the presence of foreign banks in emerging and developing markets. These effects are

associated with the influence of foreign banks on such qualitative characteristics and parameters as:

- a) financial depth;
- b) availability of financial services;
- c) change in interest rates.

It is by these indicators that one can reasonably judge the readiness and prospects of the local banking sector's integration into the global economy or the nature and extent of such integration.

First, a significant and positive relationship between the entry of foreign banks into EMDEs and financial depth provides real grounds for developing a comprehensive and well-founded program for such entry. Analysts, experts and practitioners assume that controlled implementation of this program can lead foreign banks to success and help them achieve greater financial development and positive growth indicators. At the same time, it is also assumed that there is an inverse relationship in the issue of the influence of foreign banks on financial depth. In other words, the marginal effect of foreign banks' entry into EMDEs, as a rule, decreases as the host country becomes richer. This calls into question the universal approach to financial liberalization.

Secondly, foreign banks contribute to the expansion of access to financial services in host countries, helping to ease supply-side constraints by increasing the physical access points to financial services. But here too there is an important caveat that should be kept in mind. The fact is that there is a concept of banking concentration in the economy, the level of which is calculated "to analyze the level of competition in the banking sector, the effectiveness of its development and identify its inherent problems." Three indicators are used to calculate this level:

- 1) the share of the first five largest banks in total assets;
- 2) the share of the two hundred largest banks in total assets of the banking system;
- 3) the Herfindahl-Hirschman index for assets, equity, attracted funds and loans.

The indicator of banking concentration in the economy of EMDE hosts varies from country to country. As this indicator increases, the positive impact of the entry of foreign banks tends to decrease. Concentration allows a few large players to extract monopoly rents by holding on to information resources and exacerbating information asymmetry problems, which in turn deter new bank entry. The role of the host government is not only to provide a more attractive and supportive environment for foreign banks, but also to ensure that the entry of foreign banking capital does not result in the domestic market being dominated by a few large banks.

Third, research also suggests that greater foreign bank penetration could enhance interest rate dynamics in EMDEs. As with financial inclusion, this thesis comes with a caveat. If greater foreign bank entry leads to higher levels of bank concentration, such a market structure may weaken the interest rate mechanism, as foreign banks are able to discount changes in deposit and lending rates as an important means of achieving their profit objectives.

Fourth, emerging and developing market countries tend to be heavily dependent on imported financial resources, including from foreign banks. It is therefore predictable that foreign banks will continue to play a systemically important role in the EMDE banking sector. In this context, the countries in question need to have well-designed policies to maximize net benefits and minimize risks from allowing foreign banks into their markets. This can be achieved through ongoing and timely assessment of the costs and benefits associated with this form of financial liberalization.

An important component of the process of integrating the national banking sector into the global space is the issue of internationalization of financial services.

Internationalization of financial services is an important issue for strengthening and liberalizing financial systems in developing countries. Eliminating discriminatory attitudes between foreign and domestic financial service providers and removing barriers to cross-border provision of financial services opens the door to the penetration of foreign providers.

Based on a large-scale cross-country analysis and a number of detailed case studies, experts gathered under the auspices of the WTO and the World Bank conducted a deep and comprehensive analysis of the benefits and risks of internationalization of financial services, the consequences of opening up banking systems. Including: how stability and efficiency have increased, the relationship between capital account liberalization and internationalization of financial services, the degree of importance of the supporting structure for obtaining benefits and minimizing costs associated with opening up banking systems.

3 Results and Discussions

Based on the results of this study, the authors formulated a number of important conclusions and proposals. They can be briefly presented as follows.

A. Internationalization of financial services can help developing countries build safer and more efficient financial systems by:

- Adopting international practices and standards;
- Improving the quality, efficiency, and breadth of financial services;
- Providing more stable sources of funds.

Given the current state of institutional development of the financial systems of many developing countries, these benefits could be substantial.

B. Empirical evidence drawn by the authors of this study shows that the increased competitiveness provided by financial sector openness stimulates economic growth. In addition, the functioning of domestic banking systems is positively affected by the number of foreign market participants, rather than their market share. Increased competition may reduce the profits of domestic banks, but bank customers benefit from lower net interest margins, lower costs of fee-based services, and access to a greater variety of services.

C. Foreign and domestic financial institutions differ in their performance, interests, and operational focus. The analysis shows that the reasons for foreign banks' entry into local markets, as well as the competitive and regulatory environment, differ significantly between developed and developing countries.

D. The extent of the benefits of internationalisation of financial services depends largely on how it is combined with other types of financial reform, in particular domestic financial deregulation and capital account liberalisation. The degree of capital account liberalisation can determine the potential benefits of internationalisation. For example, the experience of the European Union shows that internationalisation and domestic deregulation can be mutually reinforcing.

E. Internationalisation of financial services, however, does not require a move to a fully open capital account. Analysis shows that such internationalisation leads to less distorted and less volatile capital flows and contributes to financial sector stability.

F. Experience shows that it is vital to strengthen the institutional structure of the domestic banking system in parallel with domestic deregulation and internationalisation. This is particularly true with regard to the regulatory and supervisory functions of the state. However, it also applies to the use of the market to discipline host country banks. Both factors can play a decisive role in minimising the potential risks associated with openness, especially when it comes to dealing with large non-performing loans. G. Multilateral agreements such as GATS (General Agreement on Trade in Services) allow countries to increase the credibility of their plans to liberalize their financial systems. In particular, such agreements can help with the sequencing of reforms. Host country authorities can rely on such

agreements to decide on liberalization at home and, after allowing a certain period of time to strengthen financial regulation and supervision, to commit to future internationalization.

4 Conclusion

Internationalization of the banking sector in developing countries brings both significant benefits and challenges. Foreign banks promote competition, efficiency and financial inclusion, which accelerates the integration of local banking systems into the global economy. However, the arrival of large international players may increase risks and force local banks to make significant changes.

Studies show that the influence of foreign banks is ambiguous and depends on the level of economic development of the country. When assessing the effects of internationalization, it is important to consider the differences between developed and developing countries. In periods of economic crisis, foreign banks can play a stabilizing role, but they can also import shocks from their own countries.

To maximize benefits and minimize risks, it is necessary to develop a strategy that ensures a balanced presence of foreign banks, supports competition and innovation, but does not allow excessive concentration of bank capital. In this context, the internationalization of financial services becomes an important tool for strengthening and liberalizing the financial systems of developing countries, opening new opportunities for their economic growth and sustainable development.

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