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IMPLICATIONS OF GLOBALIZATION ON BANKING INDUSTRY

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Abstract

Globalization have several implications on banking industy. Changes in the business environment have altered bankers' views and appropriate goals. Banks have turned away from their traditional business and trading. However, this cycle has brought about increased competition among banks and made banking a much riskier business. The present study evaluates banking industry in this changing environment. It is concluded that the future will not be an extension of the past. After three decades of growth, multinational banking seems to be changing its course as bankers have a need for new directions.

Özet

Globalleşmenin Bankacılık Sektöründeki Uygulamaları

Globalleşme bankacılık sektörü üzerinde çeşitli etkiler yapmıştır. İş çevresindeki değişiklikler bankacıların görüş ve amaçlarını değiştirmiştir. Bankalar geleneksel iş ve ticaret yöntemlerini bırakmışlardır. Bununla birlikte bu süreç, bankalar arasındaki rekabeti arttırmış ve bankacılığı riskli bir sektör haline getirmiştir. Bu çalışma değişen çevre içindeki bankacılık sektörünü değerlendirmektedir. Sonuç olarak gelecek geçmişin bir uzantısı olmayacaktır. Otuz yıllık büyüme döneminden sonra,

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uluslararası bankacılığın yeni bir yön çizgisine ihtiyacı olacağı görünmektedir.

I. Introduction

The increasing integration of the world economy and the growth of multinational business since the end of the World War II has been paralleled by the expansion of global banking activities. Banks from all major nations moved abroad aggressively to sustain their growth and protect their domestic clients from foreign competition. The term of multinational bank has come to mean a large bank with banking offices in many countries.

The international financial environment of the 1980s can be summarized as follows;

1. Volatile markets,
2. Rapid developments in information technology and telecommunications,
3. Deregulation,
4. High competition,
5. Financial innovations being more complex than the standard financial instruments available in the market place.

In 1980s, as multinational bankers looked at the world, they knew that the opportunities for international expansion were greater than they have ever been. Changes in the business environment and in perceptions have sharply altered bankers' views and appropriate goals and objectives. Banks have turned away from their traditional business and trading. However, this cycle has brought about increased competition among banks and made banking a much riskier business.

In the past decade, the severe competition pressures of the international banking business have affected both capitalization and the liquidity of banks. Competition among banks put many banks out of business.

The stability and integrity of the banking system is crucially important for a sound and healthy economy. Although banks failures increased during the 1980s, the industry's deregulation was not followed by reregulation. Banking regulations have focused more closely on banking's capital base. Basle committee of the Bank for International Settlements has put forward international capital rules which place banks on a more equal footing in international competition.

The 1980s have been proving to be years for reflection in multinational banking, an interval in which bankers are concluding that the future will not be an extension of the past. After three decades of growth, multinational banking seems to be changing the course as bankers have a need for new directions.

2. Multinational Banking

Multinational banks combine traditional banking structures and procedures with new instruments and techniques devised for more competitive world wide service (Eiteman and Stonehill, 1989:375).

Tasks undertaken by multinational banks include the following:

* Financing imports and exports (the traditional multinational banking task),
* Underwriting both Eurobonds and foreign bonds,
* Borrowing and lending in the Eurocurrency market,
* Organizing or participating in international loan syndications,
* Project financing,
* International cash management, including new electronic ways of transferring funds from country to country,
* Soliciting local currency deposits and loans with an intent to operate as a full service local bank.
* Supplying information and advice to clients, including multinational firms.

Some of the largest world banks attempt to do all of these activities. Others have found it advantageous to specialize in a selected few of the possible activities. Banks generalize or specialize according to their abilities and size, as well as their perception upon what unique services their original home clients need.

Following reasons are ten of the more popular explanations for the existence of multinational banking (Khoury and Ghosh, 1987:39):

1. Low Marginal Cost: Managerial and marketing knowledge developed at home can be used abroad with low marginal cost.

2. Knowledge Advantage: The foreign bank subsidiary can draw on the parent bank's knowledge of personal contact and credit investigations to use it in a foreign market.

3. Home Nation Information Services: Local firms in a foreign market may be able to obtain more complete information on trade and financial markets in the multinational bank's home nation than can otherwise be obtainable from a foreign domestic bank.

4. Prestige: Very large multinational banks have perceived high prestige, liquidity, and deposit safety that can be used to attract clients abroad.

5. Regulation Advantage: Multinational banks are often not subject to the same regulations as domestic banks. There may be reduced need to publish adequate financial information, lack of required deposit insurance and reserve requirements on foreign currency deposits.

6. Wholesale Defensive Strategy: Banks follow their multinational consumers abroad to prevent the erosion of their clientele to foreign banks seeking to serve the multinational's foreign subsidiaries.

7. Retail Defensive Strategy: Multinational banks prevent erosion by foreign banks of the travelers check tourist, and foreign subsidiaries.

8. Transaction Costs: By maintaining foreign branches and foreign currency balances, banks may reduce transaction costs and foreign exchange risk on currency conversion if government controls can be circumvented.

9. Growth: Prospects in a home nation may be limited by a market largely saturated with the services offered by domestic banks.

10. Risk Reduction: Greater stability of earnings is possible with international diversification. Offsetting business and monetary policy cycles across nations reduce the country-specific risk of any one nation.

Multinational Banking and International Risk Diversification

A number of studies have examined the impact of multinational banking operations on the risk and return characteristics of the multinational banking. Several studies have used portfolio theory to explain the impact of international operations. A convergent conclusion of the empirical literature in this area (with one exception) is that the total portfolio risk of a both domestic and foreign portfolio is smaller, while the return on international assets may or may not be higher than the rate of return on domestic assets (Khoury and Ghosh, 1987:41).

3. Recent Patterns Of Multinational Banking Activities

The 1970s was a period of instability which brought down the regulatory structures of an earlier era; in the 1970s traditional banking "went out of window". A dramatic extension of multinational banking began 22 years ago with the fourfold increase in oil prices that OPEC unleashed in 1973. As the world fretted over the petrodollars piling up in the OPEC countries, the world's major banks mounted a recyling effort, taking funds from the Middle East and lending them to developing countries (Bellanger, 1993:51). This move not only expanded the volume of international lending, it also led to a substantial increase in the roster of banks involved internationally.

Until about 25 years ago, bankers worked in a cosy, if enthralling, world. Before 1970 in most industrial countries, bankers were either heavily regulated or comfortably cartelised. As their old job had it, banking was as easy as 3,6,3: Money in at 3%, led at 6%, on the golf course by 3 o'clock. Since the early 1970s, however, there has been change causes by three things. Volatile markets, new technology and deregulation in response to increased competition -among multinational banks as well as non banks- made banking a much riskier business (Freeman, 1993: SS5).

Volatile Markets

The volatility was the first force change in the financial system. The turning point was the break-down of the Bretton Woods agreement in 1971-72 after which currencies floated freely. In short order came oil-price shocks and inflation of dizzying proportions accompanied by wild swings in interest rates. Thus, financial markets became far more volatile. Indeed, they were more volatile than at any time since the 1930s. The volatility that characterized the global economic environment during 1980s has not been abated.

Increasing the volatility of interest rates and exchange rates during the 1970s and 1980s created a demand for hedging instruments (or the derivatives such as futures contract, forward rate agreement, option, swap) which have not been appeared, for the most part, on bank balance sheets. That's why they are named as off-balance sheet activities. The recent increase in bank failures, especially during 1980s, has ignited components of the portfolio of banking industry. One component of the portfolio of banking industry has been off-balance sheet activities.

Rapid Developments in Information Technology And Telecommunications

The second big change was the rapid developments in information technology and telecommunications. Advances in the telecommunications and information processing technology have made it much easier for bankers to manage and monitor involvement in the global market place. Moreover, a vast global electronic market has made it possible to participate in many economies without leaving home. Technological advances also lowered the cost of transactions in terms of providing access to information and linking exchanges.

Some of the changes associated with the internalization of banking are due to technological advances that have facilitated rapid cross-border capital transfers. One concern is that financial instability in one country could quickly infect the banking industry worldwide.

In the past decade the same technological advances that have increased the transnational movement of funds have reduced bank's comparative advantage in access to financial information.

Problems arose because many of the new instruments were not caught within the supervisory net of national regulation. Moreover, the complexity of these instruments increased the difficulty of risk measurement. An immediate concern of central authorities was how to supervise and manage risk when the nature of that risk was changing with the introduction of new technologies and financial instruments.

Deregulation

The volatility of financial markets and the developments in technology leaded partially for the third big trend: Deregulation and the competition are unleashed. By the start of the 1980s, governments had recognized that financial markets could not be separated artificially from each other. The growth of the Euromarkets had shown how multinational banks and borrowers could simply side-step regulation and traditional credit relationship. As multinational bankers looked at the world, they knew that the opportunities for international expansion were greater than they have ever been. Restrictive regulations have been reduced in a number of countries, permitting on the ground operations. Entering markets, opening offices, and making acquisitions were probably easier to achieve than they were in the past.

Because of these developments, elsewhere the rigors of competition arrived more slowly. In 1992, for example, Japanese and French banks went through a bumpy adjustment to the free-market savings rates introduced in the past few years. Multinational banks have repeatedly offered cut-rate prices to get into a market and reap the rewards. However, with increasing competition, they found that it is difficult to maintain those prices to compete with another multinational bank. The result was not rewarding.

On the other hand, money market funds, which are invested in short term securities and pay high rates of interest, were the bane of bankers wherever they were allowed. Many banks lacked even the basic tools to manage the risks that such a competition brought about. European banks threw away a fifth of their profits because they did not know how to balance their assets and liability positions properly (Unger, 1992:4) For example, a Bank of England study published in 1992 found that the interest margin achieved by U.K. banks on domestic lending was generally more than double of the margin on international lending every year from 1986 through 1991.

Banks also found that they were loosing the business of their top rated corporate borrowers. Most companies no longer needed banks as intermediaries because they could turn straight to wholesale money markets to raise cash. To replace lost business may banks turned to medium-sized and then small companies which could not borrow directly from public markets. Lending to these companies was riskier, yet a combination of ignorance and competitive pressures meant that banks rarely charged appropriately for the extra risk. Banks that systematically mis-priced their credit stored up trouble in their loan books. It was inevitable that in a recession, losses would mushroom relative to the size of their portfolios (Freeman, 1993:SS7).

These are the lessons taught by banks that experienced first failures in free markets, which took place over the past decade or so. Lending outstripped economic growth in many countries because banks assumed that loan growth in many countries was synonymous with higher profits. For a while they were right. Big American banks expanded their lending at an annual rate of nearly 9% in 1981-89. Their profits grew by about 10% a year until 1987; when banks began recognizing losses on loans to developing countries. Thereafter, provisions against bad loans began to overwhelm income on good ones. Banks discovered that swift loan growth was more likely to destroy profits than to bolster them. According to a study by Salomon Brothers (Unger, 1992:4), an American investment bank, "the best single predictor of future asset quality problems is the rate of loan growth."

4. New Approaches And New Responsibilities in Multinational Banking

Regionalism

Another most important trend in the world economy is regionalism, or the emergence of what some economists call "soft trading blocks."

For some time, the conventional wisdom held that the world would take one of two very different paths either retreating to national protectionism or moving forward to the global free trade model, as exemplified by the GATT (General Agreement on Tariffs and Trade). As it turns out, the world has taken neither of these paths. Instead, national economies have responded to growing international competition by drawing together into regional agreements. And this trend has been affecting the way that banks regard a region as their home markets (Rosenberg, 1994:21).

Europe is the most clearly defined of those blocks. Many European bankers-faced with a new "domestic" market of 320 million consumers and a combined GNP (Gross National Product) of $6.5 trillion- have already started to consolidate and strengthen their European Union (EU) positions to a higher priority than new international activities. In fact, Europe bankers will probably soon describe multinational banking as activities outside the EU, not just beyond their national borders. Europe's consumer market will become a much higher priority for these banks, because it can be more stable and profitable business than many of their international activities.

A less formal, but similar, regional block has been emerging in North America, as exemplified by the North American Free Trade Agreement (NAFTA). As greater freedom for business and investments among Canada, The U.S., and Mexico continues to phase in, many bankers in North America also focus significantly on their new "domestic" market of 365 million consumers.

While the fast-growing Asia-Pasific region is not likely to emerge as a formal block comparable to those in North America or Europe, there is a question on whether it is the trade or investment in either the U.S. or Europe? Clearly, Japanese banks today are looking more closely at their home and regional markets than they have for many years.

So the trend toward regional blocks definitely has been shaping the way banks plan their international business activities, as they focus on serving expanded home markets and finding unique niche business opportunities to serve their clients between regions. Banks that attempt to generalize by serving broad consumer and business markets throughout the world will be few and far between. For one thing, banks in developing countries and emerging markets are much stronger competitors for local business now than they were even a decade ago.

Other Important Factors

Multinational bankers have responded to a number of other factors beside evolving markets and new products. The technological revaluation has altered both the opportunuties and cost structures available to banks. Senior banking executives have had to master this new technology, because it determines both how they do and how they control their business. Internal controls have become increasingly important in multinational banking, and technology is critical to implementing and understanding those controls.

Managing people has also become a major challenge for the multinational bankers. Multinational banking staffs are composed of people representing a wide range of nationalities, including an increasing number of individuals who are natives of neither the bank's home country nor the host country in which they work. The task of melding people from different cultures into an effective organization has become increasingly complex. Therefore, cultures and values are important as bank executives seek to establish the proper incentives and compensation systems for these diverse employees.

5. Changing Objectives of Multinational Banking And Capital Constraints

As a result of the rate of global integration, structural change, domestic regulation, and the severe competitive pressures, bankers have sharply altered their views about appropriate goals and objectives. Chastened by the 1980s and the evaluation in markets and products, bankers have replaced aggressive marketing and expansion efforts with a new emphasis on asset quality and rates of return. Balance sheet expansion and market share are no substitutes for earnings in building a capital base (Bellanger, 1993:53).

As financial markets began to develop during 1980s, worried regulators and bank supervisors looked for ways to contain risk, and found what they thought was a neat answer. In banking, capital has been the king. The industry's deregulation has not been followed by reregulation, but banking regulators have focused more closely on banking's capital base.

On the international front, the Basle Committee on banking regulations and supervisory practices of the Bank for International Settlements unveild in December 1987 a preliminary agreement by the Central Bank Governors of the twelve countries for risk-based capital framework that set minimum capital to assets ratio (Basle Ratio) for banks operating internationally.

The goal according to Bank for International Settlements was to replace the diversity of existing national regulations for measuring capital adequacy with a single internationally accepted standard and, by this means, to help strengthen the soundness of the multinational banking system as well as to remove a source of competitive inequality, which arises from differences in home country's regulation among international banks (BIS, 1987:3).

Basle ratio tells banks how much capital they must hold against assets of varying riskiness. They require banks to hold 8% of capital for every $100 lending. At least half of that capital must be equity or near equity ("tier 1" capital). The rest can consist of subordinated (i.e., riskier) debt, provisions against unexpected loan losses and other elements of "tier 2" capital. Although all commercial loans require the full 8% of capital banking, less risky activities have lower weightings. Home mortgages, for example, usually require half of the capital backing of ordinary loans; loans to governments of industrialized countries consume no capital.

The Basle Committee also believed that all off-balance sheet activities, increasing the risk portfolio of banking industry, should be used for the purpose of calculating the minimum capital requirements.

Central bankers devised the Basle ratio to solve the problem; the level of capital in the world's banking system relative to loans had been falling for decades. This worried them, because capital is the cushion that protects depositors by absorbing losses when loans go bad. Banks that hold as much capital as the market thinks protect their depositors against unexpected losses.

The Impact of Risk Based Capital Standards

What the accord achieved its primary aims-safer banks competing on more equal terms-is a subject of hot dispute. Banks have boosted their capital ratios since 1988, though not uniformly. Strong ones have done so by issuing equity and debt in the capital markets. Weaker banks, facing prohibitive prices for capital, improved their ratios by selling loans and restricting new lending. (At some banks bad loans had wiped out of the capital thus gained.) Even though the 8% ratio was not in force until the end of 1992, banks were required to meet a 7.25% transitional ratio at the end of 1990.

Critics of the accord point out that higher capital ratio does not guarantee a safer bank. Most failed banks in the past few years met regulatory capital standards in their final published accounts. However, there is a good reason for making capital the centerpiece of regulation. Strongly capitalized banks are not only safer an average but also more profitable than under-capitalized ones. According to a study of banks in

1983-1989, returns on capital rose after banks raised capital, mainly because their funding costs fell (Unger, 1992:6).

On the other hand, meeting capital standards has constrained many banks' activities. Combined with recession, risk based capital standards have had a dramatic impact. Banks around the world have been compelled to give up to derive for asset growth that led to today's write-offs and have instead looked for ways to boost their capital. Off-balance sheet derivatives were given indirect boost. Competition in lending has been disappearing due to the Basle Regulations. Multinational banks have shifted their priority from volume to quality sales. Thanks to the Basle Rules, banks are just beginning to lend money sensibly on the basis of a risk-adjusted return on capital. Banks deploy their capital when the return on a particular transaction meets the bank's risk adjusted profit target.

6. Evaluation And Conclusion

In closed or domestic banking system, bankers must manage their flow of assets in such a way that they can meet depositor calls. This job may be easier for banks in a system, in which there is a close association between banks and central authorities. But, in any case, participation in international activities can introduce a significant source of instability into the operations of the typical bank. The bank may not enjoy the recognition internationally than it does within the domestic economy, and may not have a stable role. In turn, the stability of funding for its international business may be easily threatened. In short, liquidity problems for a particular bank can arise abroad despite an apparently secure position at home.

The danger in multinational banking in the mid-1980's centered on the implications of a shift from bank to bond market finance, the development of instruments that escaped the supervisory net, and the problem of risk assessment in the face of new technologies. Combined, these developments presented cause for concern about loan asset quality and the general state of bank portfolios. The problem was that since 1970's, as banks increased their role internationally, domestic supervision of banks had not kept pace with bank's expanded activities. National supervisory authorities faced increasingly complex banking structures and differences in domestic regulatory philosophies.

In the past decade, the severe competitive pressures of the multinational banking have affected both the capitalization and the liquidity of banks. For example, to manage their liquidity, banks have increased their reliance upon volatile purchased funds in place of short term liquid assets. Moreover, since banks' corporate clients have increasingly raised money in capital markets rather than from bank loans, banks have become more willing to enter into large commitments in order to retain their best costumers, thus reducing their portfolio diversification. Finally banks' role as controlled risk takers has waned as their role as risk managers has grown. They preferred profitability to asset growth and pursued efficiency more keenly than the market share.

In banking, capital has been the king. The Basle Committee has put forward international capital rules that place banks on a more equal footing in international competition; however, meeting those standards has constrained many banks' activities. Moreover, banks contemplating the rest of the 1990's see that things are not turning out as they would have predicted a decade ago. 1995 became to be a year for reflection in multinational banking, an interval in which bankers have been concluding that the future will not be an extension of the past.

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