



IPM Research Center



German Economic Team in Belarus

PP/01/04

Should Branches of Foreign Banks Be Allowed to Operate in Belarus?

Summary

Belarus has still to decide whether to allow branches of foreign banks to operate within its territory and to what extent. A study of the consequences of the presence of foreign banks in the form of branches in different countries and especially in transition economies in both Europe and Asia is therefore of special relevance. This paper gives a brief overview of the implications of such a presence in some countries, emphasising two questions: 1) how to establish the appropriate supervisory arrangements for foreign bank branch operations, and 2) whether foreign bank branches actually compete in the domestic bank market, or whether they service different market segments, primarily by following their clients abroad, and are thus no real rivals to domestic banks. Evidence is provided that branches of foreign banks behave as friends rather than foes. They hardly penetrate the markets traditionally serviced by domestic banks both in developed and in transition economies, and concentrate their activities primary on wholesale operations. At the same time, foreign branches spur the domestic banks into implementing further technological development. They are also very important for *signalling* reasons, as the key motive for banks to enter foreign country markets is to follow their clients. This means that branches of foreign banks can provide badly needed support for FDI in different sectors of economy. In terms of prudential control the solution of the problem home-host country regulation is the conformity with Basel Core Principles and Minimum Standards plus harmonization, and mutual recognition of these regulations. Market access decisions should be based on assessments of whether the home country regimes apply the Basel Core Principles and the Basel Minimum Standards for cross-border supervision. Besides, entry of bank branches into Belarus should be granted to well-rated banks only. The Chinese approach of "actively " and "steadily" opening up may be of interest to Belarus, whose supervisory mechanisms are relatively imperfect. Also, at the beginning, branches of foreign banks in Belarus might be allowed to operate only with foreign currencies and engage in wholesale operations. Lastly, it should be noted that the restrictions on the legal form of the commercial presence of bank branches can be tailored to Belarus' particular needs.

Contents

1. Introduction	2
2. Types of Foreign Bank Establishments	2
3. Supervision of Foreign Branch Operations: International Experience	3
3.1. Home-Host Regulations	3
3.2 How to Protect Deposits Attracted by Branches of Foreign Banks?	6
4. Competition Aspects: Do Foreign Branches Compete on the Domestic Market?	7
4.1. European Union and North America	7
4.2 Branches of Foreign Banks in EU Accession Countries	8
4.3. Foreign Bank Branches in China	9
5. Conclusions and Policy Recommendations	10
Appendix	12

1. Introduction

Belarus has still to decide whether to allow branches of foreign banks to operate within its territory and to what extent. Therefore, the consequences of the presence of foreign banks in the form of branches in different countries and especially in transition economies both in Europe and in Asia are very relevant. The establishment of foreign bank branches frequently gives rise to much concern, and is met with a certain degree of scepticism, being considered as a double-edged sword. On the one hand, it is seen as enhancing the efficiency of the domestic banking sector by helping to attract FDI, and improving know-how and technological skills. On the other hand, relatively inefficient domestic banks may not be able to withstand the competitive pressures, which may result in destroying valuable links between enterprises and banks, and causing bankruptcies. Yet, since the 1970s, both developed and developing countries around the world have relaxed their restrictions on foreign bank branch penetration. During the last decade foreign banks have been allowed, to varying degrees, to set up branches in Central and Eastern European transition countries, and in China.

In order to better understand the problem we present a brief overview of the implications of the presence of foreign bank branches in several countries, emphasising two questions: 1) how to establish the appropriate supervisory arrangements for foreign bank branch operations, and 2) whether foreign bank branches actually compete in the domestic banking market, or whether they service different market segments, primarily by following their clients abroad, and are thus no real rivals to domestic banks. We will proceed in four parts. In Part 2 different types of foreign bank establishments and the main differences in their activities are discussed. In Part 3 we present information about the international experience concerning supervision of foreign branch operations. In Part 4 we consider the question how foreign branches affect the host country banking market. The final section gives conclusions and policy recommendations.

2. Types of Foreign Bank Establishments

Before turning to the issue itself, it will be useful to list the possible types of foreign banking establishments in a domestic banking market, and to determine the main differences in their activities.

- **A representative office of a foreign bank** is an office established by a foreign bank in a host country for the purpose of representing that foreign bank. The business activities of a representative office are limited to promoting a connection between the head office of the foreign bank, and the banking and financial institutions, companies, and private and public institutions operating in the host country. A representative office provides information on the general economic conditions, business trends and investment opportunities in the host country, so as to permit the parent bank to inform its customers. A representative office is not permitted to be engaged in any banking activity, such as taking deposits, signing commercial banking agreements or negotiating loan transactions, nor may it open accounts for a client or transfer funds to or on behalf of a client.

- **A branch of a foreign bank** is an operating entity, which does not have a separate legal status and is thus an integral part of the foreign parent bank. Empirical evidence has shown that the range of permitted activities of foreign branches and the scope of their penetration into domestic banking systems varies from country to country and depends largely on the banking regulations existing in the host country.
- **Joint ventures** are a legally independent banking institutions incorporated in the host country where their principal operations are conducted and controlled by two or more parent institutions, some of which may be foreign banks.
- **A subsidiary of a foreign bank** is a legally independent institution incorporated in the host country, which is wholly owned or majority owned by the foreign bank.

These definitions enable us to emphasise the most important feature of foreign bank branches as compared to subsidiaries and joint ventures, i.e. a branch of a foreign bank is not a locally incorporated entity. That fact suggests a set of questions concerning supervision, protection of deposits, and so forth. The next chapter examines the international experience of dealing with the issue of supervision.

3. Supervision of Foreign Branch Operations: International Experience

3.1. Home-Host Regulations

Basel Core Principles

Under the **Basel Core Principles for Effective Banking Supervision** (short: Core Principles), *branches - with the exception of liquidity requirements - are subject to home state regulation.* This fact generates the crucial 'home/host' distinction, which means that an autonomous macro-prudential policy is likely to be ineffective if branches of foreign banks are present. Therefore the banking supervisory system of the country from which the branch of the foreign bank originates should be assessed for its compliance with the *Core Principles*, which recommend that host countries should allow foreign banks to branch only when the home country supervision is **adequate**. The Core Principles have effectively defined "adequate". Principle 25 presumes that "*Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.*" The more the home and/or the host country's regimes differ from the international norm, the greater the incentives and opportunities for adverse selection of risks between the different regimes.

Box 1: Bank for International Settlements. Basel Committee on Banking Supervision.

The Bank for International Settlements (BIS) was established in 1930. It is the world's oldest international financial institution and remains the principal centre for international central bank cooperation. Since 1930, central bank cooperation at the BIS has taken place through the regular meetings in Basel of central bank Governors and experts from central banks and other agencies.

In the monetary policy field, cooperation at the BIS focuses on managing cross-border capital flows, regulatory supervision of internationally active banks, and financial stability in the wake of economic integration and globalisation.

The Basel Committee on Banking Supervision is one of the BIS committee, established by the central bank Governors of the Group of Ten countries at the end of 1974. One important objective of the Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign banking establishment should escape supervision, and that supervision should be adequate. To achieve this, the Committee has issued a long series of documents since 1975. The most important of these are *The Basel Concordat and Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments*. There are sets of principles governing the supervision of foreign bank establishments by parent and host authorities, and for helping to reduce the risk that licenses are granted to unsuitable foreign banking applicants.

Over the past several years, the Committee has moved more aggressively to promote sound supervisory standards worldwide. In close collaboration with many supervisory authorities, the Committee in 1997 developed a set of "*Core Principles for Effective banking Supervision (Core Principles)*" which provides a comprehensive blueprint for an effective supervisory system.

The international experience of regulating the activities of foreign bank branches confirms the above statements. Thus, the UK's FSA (Financial Services Authority, the regulator of all

providers of financial services in the UK) bases its market access decisions on its assessments of whether the home country regimes apply the Basel Core Principles.

Minimum Standards

Besides the Core Principles, the Basel Committee set out special guidelines for the supervision of a bank's foreign establishments, known as the *Minimum Standards*. They encompass four standards, which the host country supervisory authority is encouraged to apply when assessing its relations with the supervisory authorities in other countries. In particular, whether, the home country supervisory authority of a bank or banking group seeking to establish a branch has the necessary capabilities (statutory powers, past experience, scope of administrative practices) to meet these minimum standards. The empirical evidence of how different countries apply these Standards would seem to be of practical relevance when discussing the issue whether to allow foreign banks to branch in Belarus.

Minimum Standard 1: *All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision.*

In the US, the 1991 Foreign Bank Supervision Enhancement Act, amending the International Banking Act, allows the Federal Reserve Board to grant a US banking license to a foreign bank only where it is "subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country".

Since February 1992 foreign bank branches have been permitted to operate in Australia. The Australian Reserve Bank established appropriate supervisory arrangements for branches of foreign banks, including a) mandatory compliance with the Basel Minimum Standards and the Basel Core Principles of the supervision conducted by the home country supervisors of foreign bank branches, and b) examination of branch operations by Australian supervisors. In other words, the arrangements presuppose that before granting banking authority to a foreign applicant it should first be assessed under the Basel Committee's principle of consolidated supervision whether the home country supervisors do capably perform consolidated supervision and are meeting the Basel Minimum Standards for cross-border supervision¹. This has not meant making a detailed assessment of the home country supervision against the Basel Core Principles, but requires an assessment of whether a foreign supervisor uses the Basel Capital Accord framework². In addition, a signed undertaking is requested from the home supervisors to confirm that an applicant's home country supervisors apply the Basel supervisory framework. Secondly, foreign bank branches have received credit risk visits every two to two and a half years as part of the licensing process.

Minimum Standard 2: *The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's and, if different, the banking group's home country supervisory authority.* In practice this means that consent by a host country authority for creation of a branch of a foreign banking establishment should only be considered if the appropriate home country authorities have first given their consent to the bank or banking group's outward expansion.

For example, in Venezuela applications to open branches of foreign banks and financial institutions must be accompanied by the following additional documents: 1) articles of incorporation and bylaws of the parent company, and the authorization for their existence in the country of origin; 2) evidence that the applicant company can legally, according to its articles and the laws of its country of origin, open branches in the Bolivarian Republic of Venezuela; 3) financial statements duly audited by independent public accountants and the five latest annual reports. 4) The portion of capital allocated to its operations in Venezuela, which must be equal to or greater than the minimum established in the law for each type of bank or financial institution, along with evidence, acceptable to the Superintendency, that payment has been made and that the capital is available in Venezuela; 5) evidence of the reciprocity granted, if applicable; 6) Any other information that is recommended or necessary for a full evaluation of the application, in the opinion of the Superintendency.

¹ Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments (July 1992), Information Flows Between Banking Authorities (1990) and Principles for the Supervision of Banks' Foreign Establishments (also known as the Concordat).

² If the home supervisor had previously been accepted, it has not been usual to undertake another review of its supervisory framework.

In Armenia, in order to obtain a license to perform banking operations, branches of foreign banks should submit a certificate issued by a leading bank of the country of origin attesting the solvency of the institution in question, and guarantees from at least two foreign legal entities concerning its financial standing. In order to ensure that there is equality of competition among all banks, the Armenian Central Bank may request additional information or documents from the founders, foreign banks, joint ventures and shareholders (owners) of branches of foreign banks.

Minimum Standard 3: *Supervisory authorities of the home country should have the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor.*

Minimum Standard 4: *If a host country authority determines that any one of the Basel Minimum Standards is not met to its satisfaction, that authority should impose restrictive measures necessary to satisfy its prudential concerns consistent with these Minimum Standards, including the prohibition of the creation of banking establishments.*

Starting in April 2001, the Reserve Bank of New Zealand has required some banks to incorporate locally. Such banks are from jurisdictions, which New Zealand deems to have inadequate regulation (i.e. inadequate disclosure requirements). Another category: banks whose liabilities (net of amounts due to related parties) exceed NZ\$10 billion.

The Act on Banks (Article 5k) of the Czech Republic requires that when the competent authority of the host state ascertains that a branch of a foreign bank providing services within its territory is not complying with the legal rules in the areas falling within the powers of the host state, it shall require that branch of the foreign bank to put an end to that irregular situation. If the branch fails to take the necessary steps, the competent authority of the host state shall inform the supervisory authority of the home state accordingly. The supervisory authority of the home state shall, at the earliest opportunity, take the necessary measures to ensure that an end is put to that irregular situation, and shall communicate those measures to the competent authority of the host state. If, despite these measures, the branch of the foreign bank persists in violating the legal rules, the competent authority of the host state may, after informing the supervisory authority of the home state, take the necessary measures to put an end to the irregular situation and, in so far as is necessary, to put an end to the activities of the branch within the territory of the host state and to safeguard the interests of depositors, and the bank's clients.

In addition to the general approaches on supervision of foreign bank branches defined in the Minimum Standards, there are also the *Principles for supervision of banks' foreign establishments by parent and host authorities*³, which consider three different aspects: solvency, liquidity, and foreign exchange operations and positions. These Principles provide the host country with additional procedures to insure the financial soundness of foreign branches.

Supervision of solvency

The solvency of a branch of a foreign bank is indistinguishable from that of the parent bank as a whole, thus supervision of solvency is primarily a matter for the home authority. At the same time, the monitoring of the financial soundness of foreign branches is part of the general responsibility of the host authority, therefore certain host authorities have imposed "*dotation de capital*" requirements on foreign branches operating in their countries. On the one hand, this does not contradict the Principles, but on the other, it obliges foreign branches to make and to sustain a certain minimum investment level in the host country. Furthermore, it helps to equalise the competitive conditions between foreign branches and domestic banks.

For example, the Reserve Bank of New Zealand has recommended an 8% minimum capital requirement on foreign bank branches.

In Australia a high capital adequacy ratio is imposed whenever a foreign bank branch is being authorised, with which the host country supervision is relatively unfamiliar, or where the parent bank has not had a long history of performance, on which to base judgement.

³ In May 1983 "The Principles for the supervision of banks' foreign establishments by parent and host authorities" were created. They replace the 1975 "Concordat" and reformulate some of its provisions.

Supervision of liquidity

The primary responsibility for supervising the liquidity aspects rests with the host authority, which is often best equipped to supervise liquidity as it relates to local practices, regulations, and the functioning of the domestic money markets. This does not contradict the need for the branch liquidity to also be controlled directly by the parent bank, since it cannot be viewed in isolation from operation of the bank as a whole.

Transition economies as well as developing countries, which are more vulnerable to external financial shocks than developed countries, quite often impose a variety of requirements on the activities of foreign bank branches.⁴ For example, according to Act of Banks⁵ of the Czech Republic, the supervisory authority of the home state shall perform supervision of the branches of banks or eligible financial institutions, while the supervisory authority of the host state shall perform supervision **of their liquidity**. Branches are subject to the measures adopted by the host state as part of its monetary policy. In the area of monitoring the risks arising from open positions on the financial market within the territory of that state, the host state may require that bank branches or eligible financial institutions provide the same information as it requires from banks or financial institutions having their registered offices within the territory of that state. The host state may require that banks or eligible financial institutions having branches within its territory report periodically on their business activities within its territory in the form of statistical data. Branches of foreign banks shall supply on their premises written information in the Czech language on the terms and conditions applying to the acceptance of deposits, the provision of credits and other banking transactions and services and on their participation in any payment system. On request, they shall supply information on the rules of the relevant payment system. A foreign bank branch shall also supply information on its activities and financial indicators to the extent and in the manner provided for in a Czech National Bank provision promulgated in the Bulletin of the Czech National Bank. A foreign bank branch shall keep records of all agreements entered into with clients in such a way that it is able, at the request of the Czech National Bank, to submit the relevant documents at the earliest opportunity in a verified translation into the Czech language. Besides branches of foreign banks shall introduce effective mechanisms for dealing with client complaints and supply clear written information about these mechanisms on their premises in the official language or languages of the states in which they carry on their activities.

To summarize: International experience has shown that the solution of the problem of the *home-host country* relationship is being in conformity with Basel Core Principles and Minimum Standards plus harmonization, and mutual recognition of their regulations. Besides, close cooperation among the supervisory authorities appears crucial.

3.2 How to Protect Deposits Attracted by Branches of Foreign Banks?

One of the main concerns of the host country is the protection of deposits attracted by branches of foreign banks. Such deposits should be covered by using any of three possible scenarios:

1) By a host country deposit insurance scheme. Twenty-five countries including the USA, the UK, Belgium, Sweden, Germany, France and Canada require all branches of foreign banks to participate in their deposit protection schemes, because the deposit insurance systems would not be fully effective if deposits in foreign bank branches were not protected. Thus, Slovakia's Special provision (part five, article 38) states that the deposit obligation is an obligation to deposit in a special account at the bank in the interest of currency stability and for a certain period of time, a specified percentage of the volume of deposits attracted by **branches of foreign banks within the country**.

2) By the host country deposit insurance system only if no such scheme is available in the home country or if the home country deposit insurance does not provide equivalent (to host country) coverage. Thus, in Italy participation in the Italian system is required for branches of EU or non-EU incorporated banks only if a foreign bank wants to integrate the protection offered by its home country system, or alternately, if the home country system is not equivalent to the Italian one. Article 11 of the Act on Banks of the Czech Republic establishes

⁴ For relevant information see GET PP/01/03 "Belarus' Accession to the WTO: the Banking Services Dimension".

⁵ Article 5j.

that foreign bank branches shall supply written information in the official language or languages of the state in which they carry on their activities about the manner of payment of compensation from the Deposit Insurance Fund or any other insurance scheme to which they belong, and about the manner of making a claim with the Deposit Insurance Fund or any other insurance scheme to which they belong.

3) By a home country deposit insurance scheme. This applies mainly to the European Union where branches of institutions incorporated in other EU countries are covered by their home state scheme. In Belgium and the United Kingdom, exceptions may additionally be made for overseas institutions covered by a home-country scheme that provides equivalent coverage.

4. Competition Aspects: Do Foreign Branches Compete on the Domestic Market?

4.1. European Union and North America

The interesting question is thus whether foreign bank branches have in fact been able to penetrate markets traditionally serviced by domestic banks or whether their activities have been confined to relatively small market niches. In Europe, financial market deregulation has been shaped both by the abolition of capital account restrictions and the adoption of common legislative standards in the banking field. With the Second Banking Directive (1993), which prescribes the principles of mutual recognition of banking licenses, of minimum harmonization, and of home country control, the EU financial system has been comparatively open to foreign competition and capital flows. Despite this openness for foreign competition, the EU banking market has been characterized by the low degree of penetration by foreign commercial banks in the form of branches in particular from outside of the EU (see Appendix, Table A1).

The evidence on the role of foreign banks on European markets shows that foreign bank branches are active primarily in the wholesale banking segment while their commercial banking activities remain modest. Foreign bank branches tend to supply their services in relatively small market niches. For instance, in Germany the market shares of foreign bank branches are around two to three percent in the deposit and lending businesses of non-bank customers, respectively. On the contrary, they have occupied substantial market shares in the off-balance sheet business, in investment banking as well as in mergers and acquisitions (M&A). Foreign banks are rather active on the Frankfurt Stock Exchange and on the German Futures and Options Exchange, and in the underwriting business. As Table A1 shows, a lower degree of 'inward internationalisation' of domestic banking systems could be observed in Austria, Finland, Netherlands, Portugal, Denmark, Germany, Italy, France, Spain and Sweden at the end of 1999. One possible explanation is that domestic banks have been able to establish closer links to retail customers than foreign bank branches, for which the following reasons are commonly put forward:

- Since the costs of handling credit applications and assessing the credit risk of a customer are positively related to the institutional and cultural proximity of a bank and a client's company, we would expect foreign branches to service a different market segment than domestic banks and to deal mainly with foreign clients.
- The fact that domestic banks might possess some first-mover advantages and information about the reaction of their competitors additionally suppresses the supply of loans by foreign bank branches to domestic clients.
- The fixed costs of market entry need to be taken into account. If operating profits do not cover these costs, foreign bank branches may not enter the domestic market.
- The low degree of foreign branch involvement in the deposit business reflects the fact that this kind of foreign establishment is on the average less dependent on local deposits, since it can get financing relatively easily on the international money market or directly from its parent bank.

The above reasons prove that foreign bank branches rarely penetrate the markets traditionally serviced by domestic banks because of the competitive disadvantages the former face in assessing credit risks and raising deposits from domestic clients.

Yet, it was found that the motivation to 'follow their customers' has not been the only reason for foreign bank branches to enter the US market. The evidence suggests that gradually, foreign banks have also entered the market of domestic banks. Therefore the US imposed

some restrictions on the activities in which foreign branches are permitted to engage. In the USA the regulations governing the operation of state-licensed U.S. branches of foreign banks (FDIC Part 346) ensure that foreign banks do not receive an unfair competitive advantage over U.S. banks in domestic retail deposit taking. Branches of foreign banks may not accept deposits of less than USD 100,000 from US citizens and residents.

Even in London, the world's biggest banking centre, the FSA permits 'wholesale-only' deposit-taking for foreign branches. The same holds true for Canada and for Australia. Foreign bank branches may be authorized in Canada under the 1991 Bank Act, but these branches may not accept deposits of less than CAD 150,000. In Australia **branches of foreign banks** derive substantially all their deposits from wholesale operations. In addition, foreign bank branches are prohibited from accepting initial deposits (and other funds) of less than AUD 250,000 from individuals and non-corporate institutions, and are required to disclose to customers that they are not subject to the depositor protection provisions of the Banking Act.

Obviously, the result of this overview of the activities of foreign bank branches in the EU, and some other developed countries are not immediately transferable to the case of transition economies since there are great efficiency differences between foreign and domestic banks, which might ease the penetration by foreign bank branches of the host country's banking sector. In addition, foreign banks from developed market economies enjoy a positive reputation in transition economy markets. However, the remainder of this paper also suggests that the comparative advantages of domestic banks in dealing with local customers are difficult to overcome by foreign financial institutions entering the banking sector of transition countries.

4.2 Branches of Foreign Banks in EU Accession Countries

At present, foreign investors own more than two-thirds of the banking system in accession countries; branches of foreign banks are permitted to operate, and may provide a full range of banking services.

Czech Republic

In accordance with the Act on Banks, activities of foreign bank branches are permitted in the Czech Republic. Despite the fact that the share of foreign branches is fairly high, i.e. 26%, they have not entered retail banking. Neither have they developed an extensive branch network competing with domestic banks, especially in the field of electronic banking (table 1).

Table 1. Branches of Foreign Banks in the Czech Republic

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Banks, total	52	55	55	53	50	45	42	40	38
of which: Foreign bank branches	7	8	10	9	9	10	10	10	10

* end of period.

Source: CNB.

Table 2. Banking Sector Structure in the Czech Republic

	1996	1997	1998	1999	2000	2001
Total assets						
Large banks	72	67	64	62	59	58
Medium sized banks	14	17	18	19	22	22
Small banks	3	3	3	2	2	3
Foreign bank branches	9	10	10	12	12	12
Building societies	2	3	4	5	5	5
Total credits (gross)						
Large banks	79	75	71	66	59	59
Medium sized banks	10	13	15	18	23	23
Small banks	3	3	3	3	3	3
Foreign bank branches	7	9	9	11	11	11
Building societies	0	1	2	3	4	4
Total clients' deposits						
Large banks	82	78	73	72	72	69
Medium sized banks	8	11	14	15	14	17
Small banks	2	3	2	1	1	2
Foreign bank branches	3	4	4	4	4	4
Building societies	4	5	7	7	9	8

* end of period, %.

Source: CNB.

Despite the large overall number of banks, and in particular of foreign banks and foreign branches, the market remains dominated by a few large institutions (table 2). The market share of the foreign bank branches has been fairly small but has slightly increased since the mid 90's in terms of total assets and total credits (to 12% and 11% respectively), and has been keeping at the same level, i.e. 4%, for primary deposits.

Hungary

The Hungarian legal regulations are compatible with the EU legislation in many respects. They allow European banks to provide services in Hungary through branches. The regulations concerning the opening of branches still include certain restraints, the most important of which is the **endowment capital requirement**. This restriction must be terminated upon accession to the EU. It is fairly difficult to forecast what consequences this further liberalization of branch opening conditions will have, since foreign investors already own more than two-thirds of the banking sector and a number of these banks already operate like branches. The tendency of transformation subsidiaries currently operating in Hungary into branches is not expected to have a significant influence on the banking market, as the transformation has a limited impact on the retail market. Servicing individual clients and creating the required infrastructure is a very costly process. Moreover, the European experience has shown the growth potential related to traditional banking activities (deposit collection, lending, and payment transactions) to be very low. Therefore, foreign banks wanting to enter this field will probably want to make their own way by exploiting new technological innovations (Internet, mobile and telephone banking). These developments are likely to spur Hungarian banks into implementing further technological processes.

Lithuania

Foreign banks started opening branches in 1997. There are 4 branches (table 3) at this time (one from Poland, one from Finland, and two from Germany). Branches of foreign banks have intensified competition recently, but mostly in the loan market, since they operate only in the capital market. Their weight is growing quite rapidly. By the end of 2001 their market shares in terms of assets, loans and deposits had increased to 7%, 10% and 3% respectively up from 4%, 5% and 2% at the end of 2000. Nevertheless, none of the foreign bank branches had assets in excess of EUR 100 m.

Table 3. Ownership of the Banking Sector in Lithuania

	Domestic institutions			Foreign banks			Total	Total
	State owned	Privately owned	Total	Foreign owned	Foreign controlled	Branches		
Number of banks	1	1	2	6	1	4	11	13
% of banking assets	12	2	14	78	1	7	86	100

* end of 2001.

Source: Bank of Lithuania.

The empirical evidence with regard to transition accession countries confirms that similar to developed countries foreign bank branches tend to focus on wholesale banking and their activities have been confined to relatively small market niches. One of the striking features of the opening of the banking sector in Central and Easter European transition countries is the high degree of "outward liberalization", and the absence of restraints on the activities of foreign bank branches. Yet, the high degree of foreign involvement in the banking sector coincides with improvements to the legal regulations instituted in transition accession countries, which are required in order to be compatible with the legislation of the EU.

More relevant for Belarus is the experience of certain transition and developing countries, which have opened their financial markets to foreign competition, that imperfect supervisory mechanisms can cause risks. With that concern in mind, the Chinese policy of opening up the banking sector is of special interest.

4.3. Foreign Bank Branches in China

One of the most important points in China's opening up process, especially in respect to the financial sector, is that China has been adopting an active but steady policy. "Active" means that China states that the policy of opening up is a fundamental national policy required to adapt itself to the trend toward economic globalisation. In other words, with today's development toward economic globalisation it becomes reasonable to carry forward an active

and steady process of opening up the financial industry. The objective of this policy is to fully exploit and utilise both domestic and foreign markets and resources, and to speed up economic construction and reform. "Steady" means that the process of opening up should be carried out step by step, and take into consideration that the existing imperfect financial supervision mechanisms for the banking system could easily cause risks should the country open its financial markets prematurely. Over the past 20 years, China has used this prudent principle to open its financial industry, paving the way by stages, levels and steps.

Thus, China has been opening its financial industry actively and steadily according to its capability of self-management. To facilitate the growth of foreign trade and direct investment, China first allowed foreign banks to set up representative offices in Beijing soon after the reform program started. Since 1985, foreign banks as branches have been allowed to engage **only in foreign currency business** in special economic zones and selected cities. In March 1997, the New Pudong area of Shanghai was designated as the first location to allow foreign bank branches to engage in RMB⁶ (local currency) business, though on a very restricted basis. Foreign banks can do local currency business only within joint ventures in Shanghai. However, consumer banking with Chinese citizens is prohibited. In 1998, the People's Bank of China increased the number of pilot cities for RMB business by foreign bank branches by approving Shenzhen City. To protect domestic banks and control the money supply and the foreign debt, China's government has carefully controlled and monitored the entry and scope of foreign bank operations.

Despite these barriers, however, foreign banks have grown in response to more total trade and the improving political stability of the Chinese economy. By the end of 1999, China had 74 foreign banks from 18 countries, with 161 branches in 22 cities. The key motive for bank branches to enter the Chinese market **is to follow their customers in trade and investment**. A fairly typical example is the Chase Manhattan Bank, which set up its first branch in Tianjin in 1993 to service its major corporate client, Motorola, which had moved into this market. Asian banks, mostly from Japan, Hong Kong, Korea, and Singapore, accounting for more than half of the total number of foreign banks in China (December 1999), also started business because of **the high level of trade and direct investment** between China and Southeast Asia. Other non-Asian banks that have established a large network of operations in Hong Kong, such as HSBC, Standard Chartered, Citibank, Chase, and Bank of America, have adopted a multi-branch strategy in China and maintain a competitive edge.

In spite of the East Asian financial crisis, China is maintaining its financial opening up policy. By the end of August 1999, 25 foreign banks had been permitted to do RMB business (deposits from foreign-invested enterprises and foreign citizens and RMB re-loans of foreign banks to China-invested enterprises), among which 6 banks are in Shenzhen and 19 are in Shanghai.

In 2000, the People's Bank of China cancelled the regional restriction on foreign banks, allowing them to establish branches in all central cities. Although the growth of foreign banks has been rapid, their penetration of the Chinese market is still very limited due to restrictions on branching. At present, the total assets of foreign banks in the Chinese banking system comprise only about 2.5% of the country's total, and the number of foreign bank branches represents about 1.5%.

5. Conclusions and Policy Recommendations

This paper gives an overview of the implications of the presence of foreign banks in the form of branches in different countries and regions, varying from developed to transition economies, in Asia, America and Europe. Since some concerns remain in Belarus regarding the establishment of appropriate supervisory arrangements for foreign bank branch operations, and the possibility that foreign bank branches turn out to rival for domestic banks, we have put special emphasis on these issues. In sum, our findings show:

- Branches of foreign banks rarely penetrate the markets traditionally serviced by domestic banks both in developed and in transition economies, concentrating their activities primary on wholesale operations.
- Foreign branches spur domestic banks into implementing further technological development.

⁶ The Chinese currency unit is called Renminbi Yuan, or RMB.

- Foreign bank branches are very important for *signalling* reasons, since the key motive for entering the host country market is to follow their clients. This means that branches of foreign banks can provide badly needed support for FDI in many sectors of the economy.
- There is also evidence that host country conditions matter when considering foreign bank expansion, since a significant and positive relationship exists between the host country's economic growth, incremental foreign trade, and the willingness of foreign banks to set up branches in the host country.

Lastly, it should be noted that the restrictions on the legal form of the commercial presence of banks in the form of branches can be tailored to Belarus' particular needs, since there exist many possible safeguards:

- In terms of prudential control, the banking supervisory system of the country from which the branch of the foreign bank originates should be assessed for its compliance with the *Basel Core Principles*, which recommend that host countries should allow foreign banks to branch only when the home country supervision is **adequate**. The more the home (or the host) country's regime differs from the international norm, the greater the incentives and opportunities for adverse risk selection between the different regimes.
- The Belarusian supervisory authorities should apply the *Minimum Standards* in their assessment of the supervisory authority of the country from which the foreign bank branch originates. In particular, whether, the home country supervisory authority of the bank or banking group seeking to establish a branch has the necessary capabilities (statutory powers, past experience, scope of administrative practices) to meet these minimum standards.
- In addition, the *Principles for supervision of banks' foreign establishments by parent and host authorities* allows the Belarusian supervisory authorities supplementary procedures to insure the financial soundness of foreign branches, such as, for instance, a 10% minimum capital requirement, supervision of liquidity, etc.
- The entry in the form of branches should be granted to the well-rated banks only.
- Concerning the protection of the deposits attracted by branches of foreign banks, the solution could be to require all branches of foreign banks to participate in Belarus' deposit protection scheme.
- The Chinese approach of "actively" and "steadily" opening up may be of interest for Belarus, whose supervisory mechanisms are still relatively imperfect. In that vein, branches of foreign banks in Belarus might be allowed to engage only in foreign currency and wholesales operations during the first stages, for instance.

Authors: Irina Tochitskaya, Ricardo Giucci, Igor Pelipas (lector)

Minsk, February 2004

Appendix

**Table A1. Institutional Framework of the Banking Sector in the EU
(as of end of 1999)**

	Number of Institutions	Number of Accounts (thousands accounts)	Value of accounts EUR billions
Belgium			
Total banks	121	13658	46.90
Branches of foreign banks	44	-	-
of which EU based	30	-	-
Denmark			
Total banks	192	9228	395
Branches of foreign banks	15	-	-
of which EU based	13	-	-
Germany			
Total banks	2995	83787	420.5
Branches of foreign banks			
of which EU based	88	-	3.22
Greece			
Total banks	58	1583	4276
Branches of foreign banks	22	70.5	289.7
of which EU based	13	31.2	138.8
Spain			
Total banks	287	72267	219
Branches of foreign banks	52	54	1.2
of which EU based	40	49	1.0
France			
Total banks	1674	66189	251.1
Branches of foreign banks	89	-	-
of which EU based	56	-	-
Ireland			
Total banks	66	10916	13030
Branches of foreign banks	29	-	-
of which EU based	26	-	-
Italy			
Total banks	878	-	366
Branches of foreign banks	57	25	1.4
of which EU based	41	18	0.9
Luxemburg			
Total banks	212	-	318.8
Branches of foreign banks	68	-	-
of which EU based	60	-	-
Austria			
Total banks	952	6.1	34.93
Branches of foreign banks	15		
of which EU based	14	19.5	0.39
Portugal			
Total banks	227	20639	39.6
Branches of foreign banks	20	75.7	0.57
of which EU based	17	72.6	0.56
Netherlands			
Total banks	123	21.1	113.8
Branches of foreign banks	31	-	-
of which EU based	27	-	-
Sweden			
Total banks	107		970.1
Branches of foreign banks	17	No	35.2
of which EU based	14	No	34.6
United Kingdom			
Total banks	506	154.1	534.3
Branches of foreign banks	244	-	-
of which EU based	114	-	-
Finland			
Total banks	344	10983	40.8
Branches of foreign banks	6	521	0.57
of which EU based	6	521	0.57

Source: European Central Bank (2000).

Table A2. Branches of Foreign Banks in Bulgaria

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Banks, total	79	81	41	41	42	30	34	34	34	34	35
Branches of foreign banks	0	0	0	2	4	4	5	7	7	7	7

Source: Bulgarian National Bank

Table A3. Number of Banking Entities in Romania (1990-2001)

	1990	1994	1996	1998	1999	2000	2001
Number of banks	27	40	45	41	41	41	41
Romanian incorporated banks	7	20	31	36	34	33	33
Banks with majority public ownership, of which:	5	7	7	7	4	4	3
– directly owned by the Ministry of Finance (state-owned)	5	1	1	1	1	1	1
– directly owned by APAPS1 (state-controlled)	-	6	6	6	3	3	2
Private-sector banks, of which:	2	13	24	29	30	29	30
– with majority Romanian equity	2	8	14	13	11	8	9
– with majority foreign equity	-	5	10	16	19	21	24
Branches of foreign banks	5	7	9	9	7	8	8

Source: National Bank of Romania.

Table A4. Development and Distribution of Bank Assets in Romania (Share in total assets, end of period)

Type of bank	1998	1999	2000	2001
State-owned or majority state-owned	71.0	46.8	46.1	41.8
Domestic private	9.0	5.7	3.0	3.0
Foreign-controlled	14.3	40.5	43.1	47.3
Romanian legal entities (1+2+3)	94.3	92.9	92.2	92.1
Foreign branches	5.7	7.1	7.8	7.9
Total banking system	100.0	100.0	100.0	100.0

Source: National Bank of Romania.

Table A5. Number of Foreign Banking Entities in Slovakia

	2000		2001	
	30 июня	31 декабря	30 июня	31 декабря
Number of banks	22	21	21	19
Foreign bank branches	2	2	2	2
Foreign bank representative offices	11	10	10	10

Source: Bank of Slovakia.