

The Impact of Multinational Banks on the Quantity and the quality of the Credit Supply in Hungary, Kenya and South Africa

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Abstract

In this paper, we study the impact of foreign financial market participation in Hungary, Kenya, and South Africa. Hungary had already a small MNB credit market presence during the socialist regime and it grew rapidly to 32% in 2000. In comparison, Kenya had a historically large presence of MNBs, stemming from its colonial days. The credit market presence of MNBs, though, declined during continued financial fragility and rose again towards the end of the 1990s. During the embargo, South Africa had a very small credit market presence of MNBs that ultimately grew to 4% of the total credit market in 2000. The growing presence of MNBs can be linked to a lack of banking services for many borrowers, especially low and moderate income households and SMEs. With respect to financial stability, there is evidence that banking practices that helped to increase financial fragility continued to thrive in the presence of MNBs in Kenya. MNBs may also have had an indirect destabilizing effect on South Africa, as domestic banks, missing strong domestic investment opportunities turned to speculative overseas investments instead. Consequently, two important public policy goals are not addressed by the growing presence of MNBs in emerging markets. First, the three countries included in this study seem to lack adequate financing for a broad range of sectors. Sector, financial stability does not necessarily improve in the face of a growing MNB presence.

Introduction

The study of multinational banks (MNBs) has become an important policy issue. In recent years, financial instability has risen in emerging and transition economies, while credit supply remains often insufficient. To improve the quantity and the quality of the credit supply, policy makers encourage the operations of MNBs through domestic and international policies. For instance, the U.S. Congress' International Financial Institution Advisory Commission proposed in the fall of 1999 that the permission of free entry of MNBs be one of four conditions to qualify for IMF loans. And the Uruguay Round of negotiations of the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS) concluded with the Financial Services Agreement (FSA) in 1997 that was meant to open borders to multinational financial service providers.

Many studies have focused on the determinants of MNB entry. Importantly, two factors seem to have helped to propel the market share to sizable amounts: growing financial fragility and increased privatization. MNB entry appears to grow after a financial crisis since crisis stricken countries need additional capital and MNBs are willing to enter troubled countries at substantially reduced costs. Similarly, during privatization efforts, many governments eased entry restrictions for MNBs, especially for those with investment banking experience, to facilitate privatization.

However, the impact of MNB entry on domestic economies has received less attention. While it seems clear that profit rates for domestic banks decline after and that there are limited spill-over effects into the purely domestic banking sector, there is only limited research on the effects of foreign participation on credit supply.

Our study seeks to broaden our understanding of the economic impact of greater entry by MNBs. Thus, we study the financial market developments in Hungary, Kenya and South Africa, to gain a sense of the impact of MNBs on the quantity and quality of the credit supply. The tentative results that we can draw that the growing presence of MNBs reduced access to credit for many borrowers, such as low and moderate income households and small and medium-sized enterprises (SMEs). Further, MNB entry does not appear to have had a strong positive effect on financial stability.

I. Background

Following Jones (1992), we define MNBs as banks with physical operations in more than one country. MNBs operate as branch offices, wholly owned subsidiaries, joint ventures or strategic partnerships. In comparison, international banks operate across borders without physical presence abroad.

Some important trends of MNB loans and deposits in emerging markets can be gathered from data collected by the Bank for International Settlements (BIS). The BIS' *Consolidated International Banking Statistics* (BIS, 2002) offers consistent data on MNB loans for emerging and transition economies. The data set reports MNB loans and deposits on a semi-annual basis from 1985 to 1999, and on a quarterly basis for 2000 and

2001. Monetary authorities of BIS member countries report the data on banks that are headquartered within their borders. The data are for banks headquartered in Belgium, Canada, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK and the U.S.. Thus, the data include most MNBs.

The presence of MNBs in emerging economies has grown quite rapidly over the past 15 years. By the third quarter of 2001, 154 out of 206 economies and territories reported MNB loans, up from 105 at the end of 1985. Total MNB loans in developing countries grew from \$33 billion at the end of 1985 to \$490 billion in the third quarter of 2001, a nominal increase of almost 1400%. Similarly, local currency deposits at MNBs grew from \$22 billion to \$440 billion over the same period of time, a jump of 1900%. Moreover, loan and deposit figures understate the true presence of MNBs in emerging economies since they exclude foreign currency loans and deposits and they do not include MNBs in offshore banking centers.

The growth of MNBs loans and deposits is uneven across regions. Total MNB loans were largest in Latin America with \$269 billion, followed by Asia and the Pacific Islands with \$119 billion, Eastern Europe with \$75 billion, and Africa and the Middle East with \$28 billion. Loan growth was fastest in Eastern Europe with a total increase of 3540% from 1985 to 2001, followed by a jump of 2460% in Latin America, and smaller increases in Asia (724%) and Africa (356%). Thus, Africa is the region with the smallest increases and the lowest level of MNB loans.

Similarly, MNB deposits, although generally smaller than MNB loans, are distributed unevenly across regions. Latin America had the most MNB deposits with \$230 billion in the third quarter of 2001, followed by \$110 billion in Asia, \$75 billion in Eastern Europe, and Africa with \$25 billion. Also, growth patterns of MNB deposits resemble those of MNB loans with a 13525% increase in Eastern Europe, a 2950% jump in Latin America, an overall growth of 1200% in Asia, and a comparatively small hike of 358% in Africa. In all regions, deposits have grown faster than loans suggesting that MNBs become less dependent on their parent companies for liabilities and that MNBs tend to increase their balance sheet liquidity, often more than domestic banks (Crystal, Dages, and Goldberg, 2001).

Host economy characteristics, characteristics of the originating economies, and MNB specifics have all been found to be significant determinants of MNB loans in previous studies.

The host economy characteristics that seem to determine MNB loans are real economic factors, financial market factors and external factors. Real economic factors determining MNB loans are market size (Khoury, 1979; Terrell, 1979; Sabi, 1994), the servicing of MNCs (Fieleke, 1977; Goldberg and Saunders, 1981; Hultman and McGee, 1989; Khoury, 1980; Kindleberger, 1983; Jain, 1986; Heinkel and Levi, 1992; Pomerleano and Vojta, 2001; Weller and Scher, 2001), real economic growth (Sabi, 1988, 1994), and country risk (Sabi 1988, 1994). Financial market aspects influencing MNB loans are underdeveloped banking markets (Terrell, 1979; Khoury, 1979; Guillén

and Tschoegl, 1999), privatization of local banks (Simonson, 2001; Lardy, 2001); greater profitability for MNBs (Mahajan et al., 1996), presence of other MNBs (Terrell, 1979; Ball and Tschoegl, 1982; Engwall and Wallenstäl, 1988; Jacobsen and Tschoegl, 1998; Guillén and Tschoegl, 1999; Weller and Scher, 2001), demand for MNB products (Cho, 1990), the regulatory environment (Aliber, 1984; Hultman and McGee, 1989), and bank price earnings ratios (Hultman and McGee, 1989). Finally, the external economic factors determining MNB loans include current account balances (Terrell, 1979; Goldberg and Saunders, 1981; Sabi, 1988, 1994; Weller and Scher, 2001), international interest rate differentials (Khoury, 1979), and the exchange rate (Goldberg and Saunders, 1981; Hultman and McGee, 1989; Weller and Scher, 2001).

Characteristics of the originating economy that affect MNB loans are its market size (Terrell, 1979; Khoury, 1979), saturated home markets (Guillén and Tschoegl, 1999), or underdeveloped home banking and capital markets (Heinkel and Levi, 1992).

Factors specific to MNBs are MNB's knowledge of international operations and of the host economy (Ball and Tschoegl, 1982; Ursacki and Vertinsky, 1992), or their reserve ratio (Terrell, 1979; Goldberg and Saunders, 1981).

Recently, research focused on the impact of MNBs on the host economy. Two issues are of concern: the credit supply and financial stability. In considering the credit supply, the debate focused on whether MNBs engage in "cherry picking" i.e., whether MNBs focus only on low risk customers, thereby leaving domestic banks with higher risk portfolios, which will lead, depending on the capital position of domestic banks, to either a credit contraction or to an expansion of risky ventures. Some case studies suggest very tentatively that "cherry picking" is not a problem (Crystal, Dages, and Goldberg, 2001). However, Weller (2000, 2001) found econometric evidence for a broad sample of emerging countries that suggests that the lending behavior of MNBs does indeed lower domestic credit due to "cherry-picking". In particular, SMEs and start-up companies are more credit constrained than they otherwise would have been (Weller, 2000). Furthermore, other research has noted an improvement in the stability of the local banking sector after substantial foreign penetration due to more efficient banking procedure (Pomerleano and Vojta, 2001; Simonson, 2001).

Findings on the impact of MNBs on the quantity and quality of credit are still inconclusive. This paper advances our understanding in two important aspects: we explore especially African countries, where the impact of MNBs has so far been left largely unexplored, and we continue the research on the effects of MNBs on the credit supply by using case studies.

II. Country Experiences

The three countries' experience with MNBs varies (table 1). Hungary had already a small MNB credit market presence during the socialist regime and it grew rapidly to 32% in 2000. In comparison, Kenya had a historically large presence of MNBs, stemming from its colonial days. The credit market presence of MNBs, though, declined

during continued financial fragility in the 1980s and 1990s, and rose again towards the end of the 1990s. Lastly, during the embargo, South Africa had a very small credit market presence of MNBs that ultimately grew to 4% of the total credit market in 2000.

With respect to credit growth the three countries differ, too. In Hungary, credit relative to GDP fell from 97% in 1985 to 54% in 2000 in the face of a rapidly rising MNB market share. In comparison, MNB credit grew in Kenya from 32% in 1985 to 46% in 1999, although the market share of MNBs declined. Finally, South Africa's credit relative to GDP increased from 60% to 77% with a rising MNB market share.

Table 1
Financial Market Data for Hungary, Kenya, and South Africa, 1985 to 2000

Year	Hungary				Kenya				South Africa			
	Deposits/ GDP	Credit/G DP	Credit/De posits	MNB Loans/Cr edit	Deposits/ GDP	Credit/G DP	Credit/De posits	MNB Loans/Cr edit	Deposits/ GDP	Credit/G DP	Credit/De posits	MNB Loans/Cr edit
1985	48.2	96.6	200.5	0.0	26.7	31.9	119.6	31.4	55.1	59.3	107.7	1.0
1986	49.8	103.3	207.6	0.6	30.4	34.9	114.9	28.9	51.2	55.0	107.5	1.4
1987	48.5	102.0	210.6	0.9	30.2	37.5	123.9	25.8	52.3	54.0	103.3	0.5
1988	42.2	91.6	217.2	1.1	28.3	34.7	122.6	44.5	55.4	56.6	102.3	0.5
1989	41.1	90.0	219.1	1.1	28.2	32.5	115.2	30.4	55.6	55.4	99.7	0.3
1990	43.8	105.5	241.1	0.8	29.7	36.0	121.1	32.2	53.8	55.6	103.4	0.3
1991	47.4	101.4	214.1	1.5	31.4	37.9	120.7	33.7	n.a.	n.a.	n.a.	n.a.
1992	56.8	96.2	169.4	0.8	36.4	37.2	102.0	31.9	50.5	58.9	116.7	0.4
1993	55.4	97.0	175.0	1.4	37.1	29.1	78.4	15.5	46.9	57.7	123.2	0.6
1994	51.5	93.1	181.0	2.0	40.6	36.2	89.3	10.0	49.0	61.9	126.2	0.5
1995	48.4	82.3	170.1	2.2	43.6	42.7	98.0	8.1	50.0	60.8	121.6	1.0
1996	48.1	72.1	149.9	4.0	48.2	44.7	92.8	7.8	50.7	63.7	125.8	2.5
1997	46.5	65.2	140.2	14.2	48.4	45.9	94.7	5.9	54.0	67.0	124.1	2.7
1998	45.6	62.9	138.1	17.7	44.7	45.0	100.6	6.6	57.1	73.2	128.2	2.9
1999	46.7	52.6	112.8	22.5	43.8	45.6	104.0	25.2	58.5	73.7	126.0	4.2
2000	46.3	53.9	116.4	32.2	n.a.	n.a.	100.9	17.3	57.1	76.5	133.9	4.2

Notes: All figures are in percent. Sources are the IMF, International Financial Statistics, and the BIS, Consolidated International Banking Statistics.

The Hungarian financial system became majority foreign owned a little over a decade after MNBs were granted entry during the post-socialist regime. The rise of MNBs was helped by a favorable tax treatment, by their high profitability, and by the fact that MNBs were welcome partners in the privatization of formerly state-owned banks. Moreover, domestic banks were ridden with poor capitalizations following poor management decisions and consequently bad loan portfolios. Bad loan portfolios did not improve quickly enough, although the presence of MNBs offered incentives to domestic banks to improve physical and human capital as MNBs used newer technologies and paid their employees better. As a result, MNBs acquired increasing shares of joint ventures with Hungarian banks, bought privatized banks, and gained control over the majority of the Hungarian banking sector. The rise of MNBs, though, did not improve the credit access to sectors that were traditionally credit constrained, such as small- and medium-sized enterprises (SMEs) because MNBs concentrated on commercial banking, and they expanded into retail banking only gradually over the last few years.

In Kenya, the presence of MNBs was a legacy of the colonial period, but this long-standing, large MNB presence did not help to avoid the financial instabilities of the late 1980s and early 1990s. Undercapitalized domestic banks extended domestic loans often based on political connections of the borrowers, rather than on an assessment of the business opportunities to be financed. The practice of politically determined loans meant that many non-creditworthy borrowers were served by domestic banks, that rigorous credit review standards were not implemented and that the quality of loans continued to deteriorate. The subsequent financial instabilities meant a concentration of credit in the large urban centres, which left many borrowers underserved. Moreover, in a response to rising financial instabilities, MNBs concentrated on the increasingly profitable business of government financing, thereby contributing to the financial constraints of some sectors of the Kenyan economy. MNBs quickly concentrated on lending to the government and to a few of their core borrowers, thereby reducing MNB loans quickly to less than one-fourth, relative to GDP, of what they were in 1985. In addition, financial liberalization (FL) led to rising interest rates, thus shutting good borrowers out.

To address the lack of financing, several micro-finance organizations began to operate in Kenya. Due to its co-operative structures, aid funding, and innovative monitoring approach – credit is given to groups of people who monitor each other – the costs of micro-financing are low and the ratio of non-performing loans are manageable. Overall micro financing provides access to credit to some underserved groups, especially female run businesses, but it is too small to offer a large scale alternative to the fragile and politically determined formal banking sector.

By the mid-1980s, South Africa was the pariah of international banking, as a result of anti-apartheid political campaigning, widespread protests, and the September 1985 default on \$13 billion in foreign debt--along with the imposition of exchange controls. The local representative offices of major international banks closed shop. Yet within a decade of the mid-1980s crisis, the situation had reversed. After the African National Congress (ANC) won the election in April 1994, political stability emerged and wild business cycle swings moderated. Conservative fiscal and monetary policies were

adopted, and FL began in earnest. Subsequently, a dozen international banks set up office in South Africa.

The South African experience with MNBs mirrors to some degree that of Kenya. The dependence on MNBs did not help to insulate the economy from the rising financial fragility and it left many borrowers underserved. Moreover, the link between greater foreign participation in South Africa and financial instability may be more indirect. The increasing presence of MNBs appears to have created a lack of funding for many borrowers who are facing rising costs of capital. Consequently, international financial competition may have lowered investment and growth. Hence, domestic banks turned to international financial market for higher, shorter term, speculative financial investments, such as loans to Russia or Brazil. As a result, the Asian and Russian financial crises easily transmitted to South Africa and led to a rapid currency devaluation, and rising instabilities in the banking sector.

III. 1 Hungary

Hungary began changing its banking system in the 1970s to modernize its financial system and to attract foreign capital. The two main changes were the establishment of commercial banks, and the permission of entry of MNBs.

After 1968, the “new economic mechanism” - a mix of socialist planning with market economy elements - Hungary’s foreign trade with western, market based economies grew. The policies of the of the Kádár-regime in the late 1970s and 1980s aimed at increasing the standard of living through closer co-operation with industrialized economies. The Hungarian government wanted to import more technology for industrial and agricultural development projects. This began in the mid-1970s under the name “HUF 45 billion Convertible Currency Export Base Developing Program” and continued through the late 1980s.

The program was intended to improve Hungary’s convertible currency position through export promotion and import substitution, but instead it worsened. This was due to the fact that a major part of the convertible currency surplus was used in transfers to other East Bloc countries and for imports of western consumer goods. Consequently, the current account balance deteriorated and foreign debt rose.

In the face of rising debt in the late 1970s and early 1980s, the government and the National Bank of Hungary (NBH) built close relationships with most leading international banks in the U.S., Japan and Western Europe. The Hungarian government and the international banks were particularly interested in establishing joint-venture banks to import new foreign capital. Subsequently, the first joint-venture bank, the Central-European International Bank (CIB), was created in 1979. The number of foreign participants in this joint venture was high, as many of the banks who had so far only lent to Hungary, were eager to get a foothold in the Hungarian market. Also, the Hungarian authorities hoped that the creation of the CIB would help to solidify relationships with

international banks and the respective home country authorities to facilitate the continuous capital inflow.

The first joint venture bank proved to strengthen the ties between international banking centers and Hungary. Other Western banks, in particular, Citibank and Raiffeisen, followed suit and established joint ventures with the NBH or other state owned entities in the mid-1980s. The joint venture banks proved to be highly profitable as they were exempt from any type of corporate taxes, since they were considered foreign entities not subject to the Hungarian tax law. The tax holiday ended with the banking law of 1991 and modifications to it and to corporate tax law in 1994-95. Joint venture banks managed to establish a large market presence due to more modern banking technology to better serve their clientele, such as computerized data processing, efficient credit appraisal, modern marketing, effective organisation, as well as reporting, training, and controlling standards.

Following the establishment of the CIB in 1979, two additional MNBs entered during the socialist regime. Citibank established operations in 1985, and Unicbank, a joint venture that included Raiffeisen-Bank and BankAustria entered in 1987. Their success was based on a physical and human capital advantage. Although, the western partner's banking technology, organisational and operational procedures were implemented quickly, although the number of expatriates at each bank did not exceed 3-4 and local professionals were appointed to key positions. Moreover, the joint venture banks' compensation were initially superior to those of domestic banks, which lead to an inter-bank brain drain. In 1987, the annual income of a department director ranged HUF 120-180 thousand (approximately USD 4-6 thousand) in the major Hungarian owned banks, while the joint venture banks' compensation was 2-3 times higher.

The first joint venture bank, CIB, started operating in 1980 as a dollar-based institution with offshore character with 34% of its initial capital of USD 20 million paid in by the NBH, and the remaining 66% from five international banks. Until the end of 1995, it was an off-shore bank and engaged only in convertible currency transactions, which helped it become a leading corporate finance institution in the 1980s (table 2). Further, it played a substantial role in the Hungarian privatization during the 1990s. For instance, CIB's capital market subsidiary was entrusted with allocating major parts of the shares of state owned companies, such as MOL (the Hungarian oil company), MATÁV (the Hungarian telecom company). CIB continued to offer lending and other services to these companies following their privatization.

Table 2
Key Figures for Early Joint Ventures, 1988-1990 (thousands of USD)

	1988	1989	1990
CIB			
Registered capital	20000	30000	30000
Capital reserve	19831	13281	15197
Balance sheet total	597615	605268	688464
Profit before tax	7875	8153	10267
after tax	7073	7316	9219
Staff number	177	224	262
Citibank			
Registered capital	620000	1000000	1000000
Capital reserve	200000	200000	200000
Balance sheet total	14120800	19304090	13687168
Profit Before tax	896089	1068241	
After tax	662323	854138	
Staff number	41	60	82
Unicbank			
Registered capital	1000000	1000000	1000000
Capital reserve	282696	518793	869481
Total of the B/S	8254302	10622955	17044115
Profit before tax	254696	479397	679058
after tax	254696	363597	511688
Staff number	69	79	85

Source: Magyar Pénzügyi és Tozsdei Almanach - Hungarian Financial and Stock Exchange Almanach, Ed. by Kerekes György, Budapest, Hungary, 1991.

Citibank Budapest Ltd. started its operation as a joint venture of the NBH (20%) and the Citibank Overseas Investment Corporation (80%) on January 1, 1986. It attracted not only many multinational corporations, but also large Hungarian companies. Consequently, it grew quite rapidly (table 2), especially due to its international background and experience in the field of custody services, the administration, registration and safe-keeping of securities. Citibank Budapest ultimately controlled 75-80% of this market.

Unicbank, the third joint venture established during Socialist rule, was established with an ownership structure that resembled that of CIB. The NBH held 20%, and international and domestic co-operative banks the rest. Unicbank's initial focus on custom made services for co-operatives and for small and medium-sized enterprises (SMEs). The expectation was to make Unicbank the primary co-operative bank. Instead, Unicbank concentrated multinational firms, and large domestic firms. Finding its new found activities exceedingly profitable, Unicbank did not hesitate giving up its original focus (table 2).

For almost all of the 1980s, the joint venture banks were the only MNBs in Hungary. Although Hungary oriented its banking system towards market based principles beginning in 1987, the operations of newly established domestic commercial banks were comparatively bureaucratic as they did not pay sufficient attention to marketing, organisation, or customer service. Consequently, the joint venture banks enjoyed fairly little competition.

A second wave of foreign entrants arrived in the late 1980s. These MNBs were attracted by the success of already existing joint ventures, the openness of Hungary compared to other Eastern European countries, and the need of the newly created Hungarian banks for capital. After the commercial side of the NBH had been separated from the central banking unit, the new banks looked for partners to increase their capital¹. The domestic partners originally insisted on holding at least 50% of the joint ventures, but as operational problems mounted and losses accumulated, their capital base deteriorated in the early 1990s, and more MNBs were needed to facilitate the privatisation of the former state owned banks.

With the introduction of the two-tier banking system in 1987, the palette of the banking community became immediately more colourful. In addition to the three joint venture banks, the commercial operations of the NBH were divided into three major commercial banks established largely along industry lines, Hungarian Credit Bank Ltd., Commercial and Credit Bank Ltd. and Budapest Bank Ltd.. Also, the former branch banks of the NBH, the Hungarian Foreign Trade Bank and the National Savings Bank, OTP, became independent.

The banks split off from the NBH initially dominated the market due to their sheer size. With little experience in a market environment, they continued to operate following old routines. Though attempts were made to improve their technology, their internal structures, operational procedures, and professional culture changed only slowly. They also lacked the skills necessary to succeed in the new environment, and under pressure from the lobbies of large state-owned companies, agricultural farms and co-operatives, these banks failed to follow prudential lending practices and to implement appropriate risk management strategies.

As a way out, the large domestic banks created fully licensed new banks with foreign partners in order to recreate the success of other joint venture banks. The Hungarian Credit Bank established two new banks with foreign partners in 1989-90, MHB-Daewoo Ltd. and Leumi-Hitel Bank Budapest Ltd.². These banks were supposed to offer services to corporate customers. When the MHB encountered problems in 1989-90, they immediately affected both joint ventures. Subsequently, Daewoo took over MHB's

¹These banks were established by splitting the NBH's business departments and commercial portfolio into three parts in 1986. The Hungarian Credit Bank (NBH), the National Commercial and Credit Bank (OKHB) and the Budapest Bank (BB).. Two other large domestic banks existed, the Hungarian Foreign Trade Bank (MKB) and the National Savings Bank (OTP), which were transformed into commercial banks in the late 1980s.

² In 1991, the MHB also participated with a 5% portion in the establishment of the Credit Lyonnais Bank Hungary Ltd., which was sold to the principal owner very short after the foundation of the joint bank.

shares of the first joint venture, whereas Leumi sold its stake to MHB, which had to write off the loss. Similarly, the OKHB established a joint venture together with Banque National de Paris (France) and Dresdner Bank A.G. (Germany), the BNP-KH Dresdner Bank Ltd., in 1991. In 1996, OKHB sold its stake to BNP and Dresdner. The BB was also established joint ventures with foreign institutions. In 1990, the BB established a joint bank with the Austrian Creditanstalt, which ended in 1991, when Creditanstalt Austria took over 100%.

While some MNBs started their operations jointly with a Hungarian partner, others decided to go it alone e.g., ING, Netherlands (1991), Volksbank, Austria (1993), ABN-Amro, Nederland (1993), Commerzbank, Germany (1993), Hypovereinsbank, Germany (1993), Deutsche Bank, Germany (1995), Rabobank, Netherlands (1995).

The main goal of these wholly owned subsidiaries of MNBs was to accompany their clients to Hungary, such as Shell, Nationale Nederlanden, Siemens, Bosch, or Ruhrgas. Most of the banks concentrated on international desks operations e.g., serving local subsidiaries of MNCs or promoting exports of their clients at home to Hungary. In addition, they also targeted large Hungarian firms as potential clients, such as Hungarian Oil Company, Hungarian Telecom, Hungarian Electricity Company. Nowadays, foreign banks follow their original strategy of providing services for MNCs, which represent a sizeable share of the market, and which provides a stable, and secure stream of profits. Due to each MNBs relatively small size, a significant and risky investment would be needed to acquire a larger market share. Hence, most MNBs are focused on servicing their MNC clientele. For instance, ING Hungary stopped its expansion strategy after investing approximately HUF 6 billion in expanding its retail business and sold its retail portfolio to Citibank Budapest in 2000.

Some MNBs, though, tried to increase their market shares rapidly by becoming involved in the privatization of other state owned banks, with mixed results. During the privatization of the large state owned Hungarian banks, Austrian Erste Bank stepped in and purchased a majority stake of the formerly merged Mezobank and Agrobank in 1997. Further, ABN-Amro (MHB), Kredietbank Belgium (OKHB), GE Capital (BB) became involved in recapitalisations³ despite the fact that the state had spent HUF 250-300 billion on bank consolidation prior to privatization. However, after ABN-Amro registered losses, it dropped its strategy to become a dominant bank and merged with the Kredietbank-controlled OKHB.

Hungary received a large amount of FDI in the 1990s. The capita inflow partially went to the financial sector, while a substantial share was directed towards the non-financial sectors. Foreign owned companies produced 3.2% of industrial GDP in 1992, and 25.6% in 1997 (Ékes, 2001). Also, foreign ownership of the total capital stock was 30% in 1996 and 38% in 1999. The increased foreign presence in the financial and nonfinancial sectors helped MNBs due to a larger capital base and a greater clientele stock.

³GE Capital was in a better position as it received state guarantees for the BB portfolio, when GE acquired control of BB in 1995. BB also had a valuable real estate portfolio, most of which was sold by GE.

Table 3 shows that while the number of banks did not increase substantially, the foreign ownership stake rose dramatically just from 1996 to 1999. The majority of Hungary's financial system, measured either by the pure number of banks (other than savings co-operatives) or asset size was under foreign control. The concentration of foreign ownership was especially pronounced among large banks (table 4).

Table 3
Structure of Hungarian banking sector

Form of banks	Number		Balance-sheet total (billions HUF)	
	1996	1999	1996	1999
Big banks	7	18	2835,1	6399,6
• In state ownership	2	1	591,9	329,8
• In private ownership	5	17	2243,2	6069,8
• In which foreign capital is at least 50%	3	14	783,4	4223,7
Medium banks	10	16	779,1	851,1
• In state ownership	3	2	213,5	243,8
• In private ownership	7	14	565,6	607,3
• In which foreign capital is at least 50%	7	12	565,6	553,2
Small banks	22	8	377,0	53,9
• In state ownership	7	0	87,6	0
• In private ownership	15	8	289,5	53,9
• In which foreign capital is at least 50%	14	6	272,7	48,0
Total bank sector	39	40	3991,2	7304,7
• In state ownership	12	3	893,0	573,6
• In private ownership	27	37	3098,2	6731,1
• In which foreign capital is at least 50%	24	32	1621,6	4824,9
Saving co-operatives	256	196	202,9	430,8
Total financial market	295	236	4194,1	7735,5

Source: Wachtel (1996), and ECOSTAT calculations based on corporate tax returns.

Table 4
Changes in structure of capital by type of owners and size of companies

Size of companies	Year	Foreign	Share of ownership (%)	
			Hungarian private	State and municipality
Big	1996	33	20	47
	1999	44	25	31
Medium	1996	31	54	15
	1999	35	55	10
Small	1996	19	69	12
	1999	29	64	7
Micro	1996	23	69	8
	1999	28	69	3

Source: ECOSTAT calculations based on corporate tax returns.

One of the reasons for the growing importance of MNBs was their profitability (table 5). In 2000, banking sector profits were two and half times those of 1999 due to rapid loan growth and shrinking bad loan portfolios. The share of bad loans shrank from 3.7% in 1999 to 2.8% in 2000. But the comparatively poor performance of domestic banks resulted from poor management and a concentration of bad loan portfolios.

The management of domestic banks was largely unaccountable to market based criteria and took many investment decisions that appeared to be borne more out of prestige than out of the realistic business assessments. In the late 1980s and early 1990s, there was no professional banking supervision in place or it was weak, no independent internal audit, and no external audit. Thus, CEOs took many prestige decisions, such as establishing joint venture banks with MNBs, where they remained the minority owners and suffered losses, as was the case with MHB joint venture with Bank Leumi, or that duplicated the bank's core business strategies, such as the MNB-Daewoo joint venture.

Table 5
Return on assets, 2000

Bank	Return on assets
Merkantil Bank	2,71
ÁÉB	2,58
Citibank	1,75
Raiffeisen	1,70
OTP Bank (National Savings Bank)	1,66
CIB	1,64
BA-CA	1,63
Credit Lyonnais	1,47
MFB (Hungarian Investment Bank)	1,20
Porsche Bank	1,12
BNP-Dresdner	1,01
Daewoo Bank	1,00
MKB (Hungarian Foreign Trade Bank)	0,90
Volksbank	0,65
Budapest Bank	0,57
IC Bank	0,38
Eximbank	0,32
WestLB	0,27
Commerzbank	0,08
Takarékbank (Savings Bank)	0,07
Erste Bank	0,03
Opel Bank	0,02
Rabobank	-0,02
Deutsche Bank	-0,04
Postabank (Post Bank)	-0,62
HypoVereinsbank	-0,75
K and H (Trade and Credit Bank)	-1,40
IEB	-1,50
Hawnha Bank	-2,40
Konzumbank	-5,50
Rákóczi Bank	-7,80

Notes: All figures are in percent. Source is Top 200, Figyelo, 2001 March

Second, during the 1990s the two waves of bank consolidation were meant to eliminate bad loan portfolios that state owned commercial banks inherited from the NBH. But the resources appeared to be insufficient, and bad loan portfolios remained high.

Table 6
Participation of MNBs in Hungarian Banking

	Large banks	Joint and foreign banks
Assets		
1990	80.2	12.0
1992	77.7	12.4
1994	76.1	19.4
1996	71.0	40.6
1999	87.6	66.1
Capital		
1992	59.6	25.4
1994	60.1	42.9
1996	55.9	52.1
1999	75.1	71.0
Personal savings		
1992	95.2	0.7
1994	88.0	1.8
1996	59.9	12.6
1999	N/A	40.8
2000	87.1	44.0
Business savings		
1992	69.3	21.3
1994	65.7	35.5
1996	59.9	58.9
1999	N/A	84.3
2000	78.5	84.3
Personal credit		
1992	99.3	0.3
1994	87.2	5.6
1996	87.9	13.0
1999	N/A	34.8
2000	74.6	43.5
Business credit		
1992	70.9	13.1
1994	68.1	28.8
1996	62.2	54.8
1999	N/A	80.7
2000	74.6	82.1

Source: Wachtel (1996), State Board of Trustees of Financial and Bond Markets.

Consequently, the balance sheet totals for MNBs reveal a few issues that have already been discussed (table 6). First, MNBs grew quite rapidly from 12% of assets in 1990 to 66% in 2000. Second, MNBs had slightly better capital adequacy ratios than did domestic banks. By 1999, MNBs controlled 66% of assets, and 71% of capital, suggesting that their higher profitability did not necessarily lead to more capital. Instead, MNBs may have built loan loss reserves faster than domestic banks, which would be consistent with findings from other emerging economies (Crystal, Dages, Goldberg,

2001). Third, MNBs are disproportionately focused on business clients and less on the retail sector. Thus, the balance sheet numbers confirm the already discussed business strategies, which indicates that especially SMEs did not benefit from the greater foreign participation in the Hungarian banking sector.

Banks tend to be reluctant to lend to SMEs since they are perceived as particularly risky. They are generally new entities with no track record, they lack transparency and professional management, and they have often complicated ownership structures. Moreover, in many cases the owners of Hungarian SMEs reside in tax havens, such as Cyprus or Liechtenstein. Consequently, SMEs face higher interest rates – about 2-4 percentage points higher than for prime customers. And most banks request mortgages and the personal real estate holdings of SME owners as collateral, which limits the businesses ability to expand.

A few MNBs targeted the retail market in the early 1990s e.g., CIB, Citibank, Creditanstalt, largely in the Budapest area. When the competition in the corporate market intensified in the late 1990s, other MNBs began expanding into the retail market as well. Hence, some MNBs e. g., ING, Citibank, Raiffeisen, have invested heavily in the retail sector since 1996 to attack the dominant position of the OTP.

The competition in the retail banking sector led to the introduction of short-term consumer loans, and an extension of residential mortgages. While consumer loans are increasingly provided by specialized financial institutions, such as Cetelem, Credigen, the mortgage sector appears to become a strategic market for expansion of all retail banks. According to information made available to the authors by the Ministry of Finance in 2001, mortgages increased from HUF 15 billion in 2000 to HUF 30 billion in 2001.

III. 2 Kenya

After rapid growth in the 1980s, the Kenyan banking sector remained plagued by financial instabilities, politically determined lending and low capital bases. Regulatory responses, including additional MNB entry, were insufficient. Hence, financial instabilities and lack of financing for many sectors remain prevalent

The Kenyan banking sector grew quite rapidly in the 1980s (table 7). While there were 23 Non bank financial institutions (NBFIs) and 16 commercial banks in 1981, there were 26 commercial banks, 52 NBFIs, 7 building societies, two development finance companies and the Kenya Post Office Savings bank in 1990. After a serious of crises, the total number of Financial Institutions was 67 in 1999. This included seven MNBs – a number that has remained largely unchanged over time.

The rapid growth of the banking sector resulted from a greater presence of NBFIs due to lower regulatory standards than were in place for commercial banks, such as lower capital requirements and no interest rate restrictions. This changed in the 1990's as bank regulation was altered and NBFIs were pressured to convert to commercial banks, especially since they became financially less stable than commercial banks.

Table 7
Financial Sector Growth, 1981-1996

Year	NBFIs	Commercial Banks
1981	23	16
1984	40	22
1985	48	24
1986	52	23
1988	54	24
1990	52	26
1993	51	33
1994	48	36
1995	39	41
1996	19	50

Sources are Economic Survey, Various Issues, Republic of Kenya

In the 1980s and early 1990s, the banking sector was characterized by financial instability and politically determined lending decisions. Both are connected as financial instability arose from low capital combined with non-performing loans (table 8).

The financial sector experienced two crises in the mid-1980s and early 1990s. In 1986, eight financial institutions were declared insolvent, prompting the government to raise minimum capital requirements for banks and building societies. In February 1992, the Central Bank of Kenya made available Kshs 600 million to the Trade Bank and the Pan African Bank due to a liquidity crisis. A scandal further undermined the industry in July 1993, when the central bank closed Exchange Bank, which was accused of foreign exchange regulation violations. The performance of the banking sector remained weak as non-performing loans rose from Kshs. 31.8 billion in 1995 to Kshs. 97 billion in 1999, equaling 35% of all loans.

Table 8
Reasons for Bank Failure, 1984 – 1996

Reasons	Proportion of Institutions
Non performing loans	21%
Malpractice of directors	14%
Unsecured advances to insiders	28%
Under capitalization	38%
Credit concentration	14%
Persistent violation of Banking Act	10%
Heavy reliance on parastatal deposits	10%
Mismatch of assets	7%
Liquidity Problem	3%
Poor asset quality	3%
Over reliance or high cost of funds	7%
Interference by directors and shareholders	10%

Source is Ndung'u and Ngugi (1998)

Financial instabilities arose also from politically motivated loans. In the early 1990s, large deposits from state-owned enterprises and National Social Security were made to banks over which politicians had some influence. Some of these deposits were turned into loans to politically connected borrowers and to companies owned by members

of the politically connected. There is no formal channel for the political direction of loans. A recent example reflecting politically motivated loans is the “list of shame” that was presented to the parliament containing the names of politicians who owe the National Bank of Kenya large amounts of non-performing loan. Another example is the Goldenberg International scandal, which involved the Exchange Bank. Here, the Ministry of Finance authorized the central bank to pay the exchange bank billions of shillings in export compensations for gold that may not have been exported. The case is still in court and the World Bank continues to pressure for its resolution.

To address the problem of financial instabilities and politically motivated lending, Kenya improved its regulatory standards in three important areas. Capital standards were raised, interest rates were liberalized and restrictions on foreign entry were reduced.

The Central Bank of Kenya is the main financial market regulator. It is charged with setting reserve requirements, ensuring adequate capital standards and other tasks described in the Banking Act. MNBs and domestic banks are subject to the same regulations and supervision.

Commercial banks are required to maintain a minimum reserve requirement. It was first introduced for commercial banks in 1969 and extended to NBFIs in 1974. It rose from 12.5% in 1969 to 25% in 1994, before declining to 20% in 1997. In addition, commercial banks were required to have a minimum cash ratio of 5% starting in 1971 (and extended to NBFIs in 1995). But banks kept excess liquidity, especially between 1993 and 1995, as excess liquidity was on average almost the same as the minimum requirement. Excess liquidity resulted from discount window restrictions placed on commercial banks. From June 1993, overnight lending by the central bank became restricted as eligible securities were limited to treasury bills, treasury bonds and government bearer bonds, and securities were discounted depending on their maturity. By April 1994, central bank lending to commercial banks was further restricted as they could only borrow for a maximum of four days at a time, they could borrow only for ten days in any month, and a penalty of 0.2% of assets per day was introduced for non-compliance.

To help stabilize the banking sector, the Banking Act was revised several times. The first comprehensive review was in 1985 following the growth of NBFIs. The major change applied to licensing of banks, such that applications had to be brought to the Ministry of Finance through the central bank, thereby supposedly increasing regulatory control over the licensing process. Also, to restrict entry minimum capital requirements were raised. In 1995, prudential guidelines included a code of conduct for directors, chief executives and other employees, duties and responsibilities of directors, chief executives and management appointment, duties and responsibilities of external auditors and loan loss provisions.

Another important change to the Banking Act in 1985 was the creation of a deposit protection fund (DPF). The DPF was also charged with liquidating the assets and paying off the liabilities of failed institutions. For instance, 11 NBFIs and 5 commercial banks were in liquidation in 1997. A total of 6.8% of the deposits was protected with

71% of protected deposits paid up. Also, 17.7% of outstanding debt was recovered in 1997, up from 16% in 1996. However, a general lack of securities documentation and unresolved court cases hampered the loan collection, contributing to an overall low ratio of loan recovery at the liquidated banks. To finance the DPF, all financial institutions contribute 0.515% of the previous year's average deposits with a minimum contribution of Kshs. 300,000.

Reacting to financial fragility, the central bank raised the capital requirements from 5% of assets in 1988 to 7.5% in 1995. In addition, institutions had to maintain a reserve fund out of profits. As long as the reserve fund was less than the paid up capital, banks were required to transfer 12.5% of their net profit each year to the reserve fund. Once they met this goal, they had to pay at least 10% of their net profits. To secure the reserve funds, the assets of the funds were supposed to be invested in government securities and other securities authorized by the central bank. Also, the Central Bank increased the minimum requirements for operating a bank to Kshs. 500 Million in 1999, but it was reduced to Kshs. 300 Million in the 2001/2002 budget.

Table 9
Minimum Capital Requirements

Institutions	1980	1982	1985	1994	1997	1999	2001
Bank incorporated in Kenya	5	10	15	75	200	500	300
Bank incorporated outside Kenya	50	100	150	200	200	500	300
NBFI incorporated in Kenya	1	1	7.5	37.5	150	500	300
NBFI incorporated outside Kenya	5	5	7.5	150	150	500	300
Mortgage incorporated in Kenya	1	1	7.5	37.5	200	500	300
Mortgage incorporated outside Kenya	5	5	7.5	100	500	500	300

Notes: All figures in Kshs. Million. Source is the Central Bank of Kenya, Supervision Annual Report 1980-2001.

Another step to help the banking sector recover was the liberalization of interest rates in July 1991. Interest rate liberalization is at the core of financial liberalization (FL) theory. The expectation is that real interest rates rise both for depositors as well as for lenders, thereby offering individuals an incentive to deposit their funds in banks and banks an incentive to lend their assets to borrowers. Consequently, the banking sector should grow, financial intermediation should improve – reflected in a narrowing spread between deposit and loan rates – and investment growth should follow suit. However, the experience showed initially negative real interest rates followed by a widening interest rate spread immediately after FL (table 10). This may be the result of several factors. In particular, the banking sector remains largely inefficient (many branches, top heavy management structure, high compensation for management and staff, and outdated technology), lacking competition, and it is burdened with large costs, such as the cash ratio or rising non-performing loan ratios. The situation is exacerbated by slow debt recovery through the courts, and a risk premium resulting from continuous financial

insecurities. For instance, the total costs of funds amounted to 25.5%, of which 6.82% were direct costs of funds (deposit rates), 1.75% the cost of liquidity, 1% the cost of cash holding, 10.37% the direct operational costs and 5.31% the costs of non-performing loans.

Table 10
Real interest rates 1973 – 1996

Year	Real deposit rate	Real lending rate	Real T-bill rate	Spread between lending and deposit rates
1973	-9.5	-4.92	-10.92	4.58
1974	-8.99	-5.43	-8.80	3.56
1975	-9.71	-5.74	-9.43	3.96
1976	-1.62	2.70	-0.82	4.32
1977	-11.71	-7.84	-15.04	3.87
1978	-6.27	-2.16	-5.12	4.11
1979	-3.68	0.55	-4.53	4.22
1980	-5.33	-1.89	-6.32	3.44
1981	-7.45	-6.58	-8.60	0.86
1982	-1.30	0.28	-1.28	1.02
1983	2.53	5.57	4.81	3.03
1984	0.69	3.28	1.49	2.59
1985	7.14	9.50	9.63	2.36
1986	-1.40	0.77	-0.87	2.17
1987	0.08	3.95	3.04	3.88
1988	-1.22	1.20	-0.10	2.42
1989	-1.17	3.23	0.37	4.40
1990	-4.61	-1.10	-3.45	3.50
1991	-0.48	3.96	2.01	4.43
1992	-14.11	-9.42	-12.50	4.69
1993	-19.05	-15.99	-9.95	3.06
1994	6.78	27.82	10.62	21.05
1995	5.43	20.50	13.11	15.07
1996	3.82	16.03	9.72	12.21
1997	7.40	20.70	17.00	13.30

Notes: All figures in percent. Source is the Central Bank of Kenya statistical bulletin, various issues.

Finally, MNBs have operated in Kenya since the beginning of the 20th century, but their presence did not expand in the wake of the recent financial crises as was the case in Korea or Eastern Europe. The first MNB in Kenya was the National Bank of India, which open its first branch in Mombasa in 1896. The Standard Bank of South Africa followed in 1910, and the National Bank of South Africa in 1916. Between 1910 and 1919 banking was controlled by the banks' headquarters in London, and between 1919 and 1966 the British colonial government established a currency board for East Africa which determined banking and financial policies in the East African Region. It was not until 1966 that the Kenyan Government broke away from the currency board to establish a central bank. By 1965, three British banks (National and Grindlays Bank, Barclays Bank and Standard Bank) accounted for 80% of all deposits.

In the late 1960s, domestic bank development followed, supported by the government. In January 1968, the Co-operative Bank of Kenya was established, and in June 1968 the National Bank of Kenya was set up as state-owned bank. Further, in June 1970 Standard Bank and Barclays D.C.O. announced a joint venture with half of the capital subscribed by the Kenyan government and a quarter of the capital subscribed each by Standard and Barclays. Also in 1970 National and Grindlays split into Kenya Commercial Bank Ltd. and Grindlays Bank International (Kenya) Ltd.. 60% of Kenya Commercial Bank's capital was owned by the government, and 40% of Grindlays Bank International (Kenya) Ltd. By 1973, two government owned banks remained, Kenya Commercial Bank and the National Bank of Kenya.

MNBs banks have operated in Kenya since 1906. Prior to Kenya's independence in 1963, eleven MNBs were presented. By the 1990s, thirteen MNBs comprised the Kenyan banking system: Bank of India (India), Standard Bank (UK), Barclays Bank (UK), ABN Amro (Netherlands), Habib Bank (Switzerland) National and Grindlays (UK), Bank of Baroda (India), African Banking Corporation (UK), Stanbic Bank (South Africa), Commercial Bank of Africa (U.S.A.), Citibank N.A. (U.S.A.), Credit Agricole (Swaziland), First American Bank (U.S.A).

Similar to other countries, MNBs attract qualified staff with high salaries. The top managers are usually expatriates. As of 2000, 12,438 people worked in Kenyan banking, of which 4,379 people worked for MNBs. By 2000, MNBs had over 53% of total banking sector assets, while they employed 30% of the sector's workforce, reflecting higher productivity.

Due to greater competition from MNBs, local banks improved their services by computerizing their operations and employing highly skilled labour. MNBs introduced ATMs and branchless banking. And modern technology led to a more efficient payments system. Partially, as a result of the technological changes, many banks closed most of their branches in smaller towns and now they serve only the major towns, Nairobi and Mombasa.

As the Kenyan financial market became deregulated, the number of financial institutions initially grew and real interest rates became negative. However, time deposits increased in the early 1990s until 1995, but they remained below the levels of the 1970s. Similarly, loans increased in real terms. One factor that may explain the growing role of commercial banks as financial intermediaries may simply reflect a shift from NBFIs (see table 7). By 1996, the level of real loans had almost reached the level of the 1970s. However, the rise in loans only aggravated the financial instabilities as the ratio of non-performing loans rose.

In response to rising financial instabilities, commercial banks allocated a growing share of their assets to government securities, aided by rising real interest rates on treasury bills (see table 10). However, the rise in government lending by Kenya's banks also meant a decline in lending to agricultural producers (table 11). Instead, credit increased in the service sector, and also slightly in the industrial sectors (table 11).

Table 11
Commercial Banks Private Credit by Sector, 1990 to 1996

Year	Agriculture	Industry	Others
1990	14.5	28.1	46.8
1991	12.9	27.8	49.0
1992	12.8	25.2	54.1
1993	14.5	27.4	51.1
1994	13.1	27.0	52.7
1995	11.0	30.3	53.7
1996	9.1	30.5	56.0

Notes: All figures are in percent. Source are the Economic Surveys, Republic of Kenya, 1990 - 1996

The financial crisis in 1986 did not affect MNBs because they had sufficient capital and a large share of their assets was in government securities. But the longstanding and large presence of MNBs in Kenya did not help to stabilize the financial sector in the 1980s or the 1990s. Hence, the capital base of domestic banks remains inadequate, while their bad loan burden stays high.

One possible explanation why the presence of MNBs did not increase financial stability may be the focus of MNBs on a few, narrow, yet highly profitable market segments, where MNBs are dominant. A large share of MNB assets is invested in central bank and government securities (table 12). Consequently, MNBs have lower loan to asset ratios than domestic banks (table 12). Moreover, MNBs grant loans to companies with which they have longstanding relationships, such as MNCs.

Table 12
Summary Statistics for Largest Banks in Kenya, 2000

Bank Name	Government Securities	Loans to Customers	Total Assets	Government Securities as share of assets	Loans as share of assets	Number of staff
Commercial Bank of Africa	3,223,350	5,017,417	12,782,554	0.25	0.39	257
ABN	1,994,000	8,818,000	15,790,000	0.13	0.56	140
AMRO Bank	2,916,000	10,042,000	22,259,000	0.13	0.45	172
Citibank N.A.	1,000,000	3,132,000	5,732,000	0.17	0.55	68
Credit Agricole	1,550,000	4,354,000	7,199,000	0.21	0.60	101
Stanbic	3,367,000	3,935,000	5,675,000	0.59	0.69	100
First American	1,500,000	4,790,000	7,442,000	0.20	0.64	132
NIC	2,130,000	1,877,000	5,170,000	0.41	0.36	107
Diamond Trust	10,363,000	44,519,000	70,377,000	0.15	0.63	1,900
Barclays	16,594,000	18,103,000	49,388,000	0.34	0.37	1,104
Standard	1,487,000	716,000	2,547,000	0.58	0.28	82
Bank of India	1,620,000	1,341,000	3,309,000	0.49	0.40	150
Baroda	1,404,000	744,000	3,113,000	0.45	0.23	65
Habib Bank	9,445,000	51,525,000	74,105,000	0.13	0.69	3,403
Commercial Bank of Kenya	2,214,546	19,566,456	23,587,569	0.09	0.82	882
Cooperative Bank	251,000	3,159,000	3,652,000	0.07	0.86	50
Development Bank	378,600	2,001,411	3,021,094	0.13	0.66	50
Victoria Bank	211,000	1,586,000	2,752,000	0.08	0.58	95
Prime Bank						

Notes: National Bank of Kenya is not listed here as it faces severe liquidity problems and an attempt was made to recapitalize it. Source is the Kenya Banks Association Report—Extracted from the banks records as of December 2000.

What was the ultimate impact of MNBs on the credit supply in Kenya? The financial instabilities of the 1980s and 1990s meant a concentration of credit in the large urban centres, which left many borrowers underserved. In addition, FL and financial fragility led to rising interest rates, thus shutting good borrowers out. Also, MNBs

quickly concentrated on lending to the government and to a few of their core borrowers, thereby reducing MNB loans quickly to less than one-fourth, relative to GDP, of what they were in 1985. Further, the practice of politically determined loans meant that many non-creditworthy borrowers were served by domestic banks, that rigorous credit review standards were not implemented and that the quality of loans continued to deteriorate.

Ultimately, many Kenyan businesses, particularly in the countryside and in the informal sector remained underserved. However, a large share of the Kenyan economy is located in the informal sector. For instance, About two-thirds of employment outside of agriculture is in the informal sector (Economic Survey, various years).

To address the lack of financing, several micro-finance organizations operate in Kenya, which are registered as cooperatives, non-governmental organizations or as micro-finance companies. Some micro-finance companies, such as K-Rep, with an asset base of Kshs. 962,638,000 have grown sufficiently to register formally as a bank. In response, the central bank decided to extend its supervisory powers to the major micro-finance organization. Already 17 micro-finance organizations have been put under central bank supervision.

Due to its co-operative structures, aid funding, and innovative monitoring approach – credit is given to groups of people who monitor each other – the costs of micro-financing are low and the ratio of non-performing loans are manageable. Overall, though, micro financing provides access to credit to some underserved groups, especially female run businesses, but it is too small to offer a large scale alternative to the fragile and politically determined formal banking sector.

III.3 South Africa

South Africa was, by the mid-1980s, the pariah of international banking, as a result of anti-apartheid political campaigning, widespread protests, and the September 1985 default on \$13 billion in foreign debt--along with the imposition of exchange controls. The local representative offices of major international banks closed shop, and the two largest South African banks--Barclays and Standard Chartered--cut their ties to the local operations through `divestment' (at firesale prices) to local corporations. Before long, the four domestic banks were in near-total command of the local market, and represented part of the dramatic centralisation of `monopoly capital' for which South Africa became famous. At the peak of consolidation in the early 1990s, South Africa's four largest banks dramatically increased their share of total bank assets, from 69% in 1991 to 84% in 1995.

Yet within a decade of the mid-1980s crisis, the situation had reversed. After the African National Congress (ANC) won the election in April 1994, political stability emerged and wild business-cycle swings moderated. Conservative fiscal and monetary policies were adopted, and FL began in earnest. Subsequently, a dozen international banks set up office in South Africa.

The South African experience with MNBs mirrors to some degree that of Kenya. The dependence on foreign banks did not help to insulate the economy from the rising financial fragility and it left many borrowers underserved. A more viable alternative may be domestically-sourced finance (plus appropriate forms of trade finance) – reflected in the ANC’s Reconstruction and Development Programme (ANC, 1994). The RDP described goals of financial regulation as accountability, transparency and extending financial services to those who presently do not have access to these services. The RDP envisaged a “Housing Bank to ensure access to wholesale finance” (backed by a Guarantee Fund), with subsidized interest rates for home loans. The RDP suggested that the state encourage community banking, by changing regulations and placing accounts in community banks. The RDP called for pension/mutual funds to be more accountable to members. The RDP also argued that in order to carry out the duties of the central bank a new board of directors was necessary to include trade unions and civil society.

Throughout South Africa’s history, MNBs were at the center of severe economic crises. The role of MNBs dates back to the early 1800s, and is often linked to South Africa’s financial booms and busts, and thus to its history of uneven development⁴.

Even though the mid-1930s and 1940s were years of growing prosperity, the age old conflict between foreign-headquartered English-speaking bankers and Afrikaner farmers remained. During the 1940s, financiers opposed the farmers’ state subsidies and took advantage of their overproduction and land speculation problems. But, once in power in 1948, the National Party focused not only on institutionalizing racial practices through apartheid, but also on overcoming ethnic imbalances in the financial system. By that time, a new class of Afrikaner financial industrial and commercial capitalists had come into existence (O’Meara, 1983). Still, only slightly more than 20% of potential Afrikaner capital had been placed in Afrikaner financial institutions. So after 1948, a number of government and NP-controlled authority accounts were switched to Afrikaner institutions (O’Meara, 1983). Financial flows went into commerce and industry via the Cape-based Afrikaans institutions Sanlam and Rembrandt,⁵ just as the apartheid state was established. Conflicts between the rising class of Afrikaner capitalists in the south and the Bond, the traditional organization of the Afrikaner petty bourgeoisie (O, Meara, 1983), led to such severe splits in Afrikanerdom in the 1970s and 1980s that apartheid could be broken.

The two decades after World War II witnessed a growing capital intensity in mining, agriculture and consumer goods production (Fine and Rumstojee, 1996). Access to international financial capital, organised by the local mining houses and stock market immediately after the war, was checked only briefly by Afrikaner nationalist threats of nationalization. A quarter of the mining industry funds were raised from mining Trust Funds in the US and Switzerland, while 7% came from new local financing sources such as the government’s National Finance Corporation, founded in 1949 to gather and deploy

⁴Bond (2001) offers a detailed discussion of the historical connection between MNBs and financial fragility.

⁵ Other key Afrikaner institutions included Federale Volksbeweging, Saambou and Volkskas.

corporate savings. The brunt of the money came from British financial institutions, which held more than half of the stock exchange shares by the mid-1950s. This drew South Africa into the global economy, but it led to such financial dependence that by the 1970s the international anti-apartheid movement discovered that it represented the country's Achilles Heel, and hence began to focus sanctions pressure on international banks.

Beginning in the 1960s, high levels of capital-intensive investment had led to chronic overproduction. Consequently, investment leveled off starting in 1973, growth declined in 1974, manufacturing employment began falling in 1975, and investment fell from 1976 on. But due to the rise in gold prices after the end of the Bretton Woods system, new capital inflows entered South Africa. These fuelled a construction boom, expansion of state-owned enterprises, and public infrastructure investment. Nearly a quarter of investment by state-owned companies from 1972-78 was funded through international capital markets. But given the continued lack of demand growth and the fact that the 1979-81 gold boom had to run its course, international banks lost confidence in apartheid and agreed to cut credit lines for all but short-term trade finance.

Ultimately, South Africa's external debt became unmanageable, and a debt moratorium on more than \$13 billion in foreign debt out of a total of \$20 billion was called in 1985. As a result of the debt moratorium and the rising domestic and international tensions over the apartheid regime led Standard and Barclays to sell their rapidly devaluing franchises to Johannesburg-based managers (funded by insurance and mining capital), who renamed them Standard Bank Investment Company and First National Bank. This in turn compelled the government to follow "loose money" policies that included encouraging credit supply to areas that were underserved, especially black townships. Liquidity grew, with private sector debt to GDP rising from 30% during the immediate post-war era to 50% during the 1980s and to more than 65% by the late 1990s.

Amid a return to tight money, anti-apartheid financial sanctions and a fear of capital flight, nominal interest rates on housing loans soared to 21%, or 6% in real terms, in 1989, pushing the country into a depression from 1989 to 1993, and resulting in a 40% default rate on the 200,000 bonds granted to black borrowers. In comparison, asset prices soared at a time when the real economy declined. From 1982-90, the Johannesburg Stock Exchange (JSE) saw an eight-fold increase in share values. The share prices of banks rose largely because of their increased profitability, which was driven by a widening interest rate spread. Interest rate spreads rose from 2.5% in the late 1980 to 3.2% by 1993, and to 4.2% by 1997⁶--with a consequent growth in profits to record levels and a huge rise in share values of banking stocks. Financial activity borne of economic crisis had helped financial institutions, while hurting real economic activity.

The divergence between financial and real economic performance also went along with a concentration of corporate wealth. Assets directly under the control of the lead owner illustrate the size of the major conglomerates. In 1993, Anglo American owned R48 billion in assets, Richemont (Rembrandt) owned R26 billion in assets, Barlows (Old Mutual) owned R23 billion in assets, Gencor (Sanlam) owned R23 billion in assets, and

⁶The spread dropped to 3.2% in 2001, still higher than historical averages (*Financial Mail*, 2001).

the three largest insurance companies (Old Mutual, Sanlam and Liberty) controlled more than R250 billion in assets (TURP, 1994). It was estimated that Anglo American and De Beers combined controlled approximately 45% of the corporate assets reflected on the JSE (Gerson, 1993). By 1995, control of the JSE by the top five corporations (including Liberty Life) had reached 80,3% (Nedlac Labour Constituency, 1996).

The oligopolistic market structure included the banking sector. Conglomerate control of the banking sector led the ANC-affiliated Macroeconomic Research Group to remark in 1993 (MRG, 1993): “The dominance of financial relations [between conglomerate centres and their subsidiaries] accounts for a system of control and accountability that is remarkably narrow in its orientation, and is focused on very short-term financial ratios rather than long-term competitiveness.” The short-term orientation of the banking sector helps explain low investment in the 1980s and 1990s. Furthermore, banks came under criticism from homeowners, consumers and small businesses in subsequent years as these groups did not receive enough funding. Homeowners complained about capricious interest rate increases, a limited range of financial products, a legacy of poorly-designed low-cost lending initiatives, a wave of foreclosures and evictions, the 1995 decision to raise interest rates for low-income homeowners (and to lower rates for professionals and high net worth individuals), and systematic redlining of black and desegregated neighborhoods.

During the early 1990s, community groups in the South African National Civic Organization criticized bankers sharply. Specific criticisms included: banks cemented the geography of apartheid by financing developers who built housing estates far away from the central cities; banks financed poor quality developers to put up shoddy housing⁷; banks charged negative interest rates on home loans as late as 1988 to solicit marginal borrowers⁸; banks had no safeguards for their own investments; banks did not serve most South Africans as they did not offer home loans below R35 000 and no facilities in rural areas; banks offered little consumer education; and there were no options for co-operatives, land trusts, or housing associations.

After the ANC took power, no actions were taken against the banks. On the contrary, the Department of Housing supported the banks in several ways after 1994: a 30% loan guarantee through the Mortgage Indemnity Fund; the commitment of R50 million for new small houses, built explicitly for people to move into when interest rates go up and banks force them out of their bigger, now unaffordable homes; no intervention when in 1995 when banks raised interest rates for low-income borrowers five percentage points above those for high income borrowers; no intervention against redlining; and a commitment to bring unpopular foreclosure action on behalf of banks against defaulting borrowers (Bond, 2000).

⁷90% of township houses had flaws, according to a Housing Consumer Protection Trust report.

⁸Those affected included pensioners and others aged 65 and older who were encouraged to take out loans to construct two rooms and a garage behind their matchbox houses. When interest rates rose only marginally, default rates rose.

As a result, consumer advice offices received more complaints about financial institutions than about any other sector in the mid-1990s. Concerns about bank practices included misleading advertising, consumer fraud, inadequate consumer education, lack of competition between banks, rising fees for financial transactions (even at Automated Teller Machines), lack of access to bank facilities for township and rural consumers, and lack of responsiveness to complaints. Because banks failed to serve low-income consumers, there was a rise sub-prime lenders in township and rural markets.

The question, though, is whether the re-entry of MNBs helped to improve banking services and financial stability after the end of apartheid. There were 56 banks with assets of more than R75 million (approximately \$9 million) in South Africa by 2001. By the late 1990s, MNBs began reentering and by 2001, six MNBs were among the top 20 banks: Citibank, Credit Agricole Indosuez, Morgan Guaranty Trust, Barclays, ABN Amro and Commerzbank (table 13). In total there are 16 MNBs in South Africa.

Table 13
MNBs in South Africa

Bank	Total assets (Rbn)	Asset rank amongst SA banks	Foreign currency loans (%)	Private sector loans (% of assets)	Contingent liabilities (Rmn)	Capital and reserves (Rmn)	Capital ratio (%)	Loan loss provisions (%)
Citibank	9.60	8	35	47	832	522	5.0	0.3
Credit Agricole Indosuez	6.27	9	73	5	435	187	2.6	0
Morgan Guaranty Trust	4.52	12	0	16	0	465	10.3	0
Barclays	4.02	16	76	3	342	58	1.3	0.5
ABN Amro	3.85	18	36	64	758	220	4.8	22.1
CommerzBank	3.31	20	22	74	1,222	274	6.0	1.1
ALL SA BANKS	821.8		9	33	100,022	72,430	7.9	2.1

The impact of MNBs on the credit supply resembles that in other countries. MNBs concentrated on large domestic and multinational corporations (Financial Mail, 2001). Also, there seems to be evidence that suggests that small businesses were shut out of financial markets due to reduced lending by domestic banks in the face of increased international financial competition (AP Reports, May 16, 2000).

There are other indications that MNBs did not have the anticipated and desired effect. A recent survey by PricewaterhouseCoopers (2001) rated the banks' assessment of the South African financial sector, in which they operate. All banks listed the arrival of foreign entrants as only the fourth most important driver of change in the banking

industry. But competition from domestic and international banks, ranked 4th out of 16 major threats that banking in South Africa is currently facing, behind economic downturn, fee and service charge erosion, and compliance and regulatory constraints).

Domestic and multinational banks also differ in the way they see their strategic goals. All banks are concerned with profit performance, client focus, service quality, improved revenue growth and retention of existing clients. But MNBs consider building a customer base, addressing new compliance and regulations and recruiting/training front office staff as the next important steps. Domestic banks, in comparison, list liquidity of banks, understanding complex products, high dependence on new technology, and increasing competition from MNBs.

Likewise, measures of successful activities varied between domestic and multinational banks. MNBs recorded their most successful activities as mergers and acquisitions, stock brokerage, structured finance for projects, treasury operations and foreign exchange dealings, and they saw the following as nonexistent or least successful activities: insurance, property finance, mortgages, retail lending and credit cards. Domestic banks considered their most successful activities to be structured products, private banking, credit cards, mortgages, mergers and acquisitions, and retail deposit taking, and their least successful activities as corporate finance, retail lending, stock brokerage and unit trusts. There is little indication that this will change as MNBs show no interest in entering retail banking or insurance markets.

Table 1 shows that the six largest MNBs have managed to gain substantial market shares. With the exception of Morgan Guaranty, all have a vast share of their assets committed in the form of foreign-currency-denominated loans. With a few exceptions, private sector lending outstrips the average of South African banks, and contingent liabilities are relatively high compared to local institutions. Further, MNBs' capital ratios are lower than for South African banks, with the exception of Morgan Guaranty, as are loan loss provisions, with the exception of ABN Amro. In other words, on the face of it, MNBs do not appear to be more financially sound than domestic banks. This clearly deviates from trends elsewhere, particularly Latin America, where MNBs have been found to have higher loan loss provisions than domestic banks (Crystal, Dages, and Goldberg, 2001).

South Africa, like many other emerging countries, underwent severe financial crises in the late 1990s. In March 1995, the currency was devalued, thereby attracting portfolio investments and financing a stock market boom (IDC, various issues)⁹¹⁰. But in February 1996, portfolio investments left the country resulting in a currency devaluation

⁹The devaluation occurred by abandoning the financial rand. The financial rand was aimed not at foreign companies that wanted to repatriate profits or investments, but at owners of financial assets. The controls served as a form of tax on outflows; the premium ranged from 10% to 40%, depending upon exchange rates and political circumstances.

¹⁰The inflow led to a rise in the monthly average share turnover from R5 billion to R10 billion within a year of the relaxation of exchange controls. The stock market all-share index, rose from 5 000 in early 1995 to 7 000 a year later.

of about 30%. Again, 30 months later, during a few weeks in mid-1998, South Africa again faced financial crisis. More than R30 billion in hard currency reserves were used by the central bank in unsuccessful attempts to defend the rand, the stock market crashed, and the central bank raised interest rates by more than 7%, slowing down the economy, and the currency fell again by about 30%.

Part of the greater vulnerability of the South African economy resulted from its banks' desire to reap large profit in international markets. South African banks engaged, during the 1990s, in a desperate search for foreign funds cheaper than those prevailing in South Africa. The funds borrowed abroad, though, were not invested in South Africa, as the four main banks and Investec sought a growing share of revenues from overseas investments. For instance, Standard Bank received approximately a quarter of its total profits from international operations, including debt market, resource banking and private banking operations (63% of international profits) and investments in African banks (37%). First Rand received 14% and Absa 6% (Financial Mail, 2001). In 1998, South African banks granted loans to Russia and Brazil when those countries offered far higher rates of returns on loans, with dire consequences, e.g. Standard Bank lost £50 million in a Russian loan after the August 1998 default. Thus, risky international financial market ventures were apparently more attractive than domestic investments for South African banks.

To put it differently, the presence of MNBs may have ultimately had a destabilizing effect on South Africa's financial system. Greater international financial competition lowered the availability of funds for many borrowers in South Africa, thereby raising their costs, and consequently lowering their investment and potential output. As a result, domestic investments became less attractive than short-term speculative financial activities on international financial markets. Thus, even though domestic banks were better capitalized than MNBs (table 13), they became more financially fragile due to the lack of sufficient investment opportunities domestically, which was partially the result of greater international competition.

IV. Conclusion

In this paper, we study the impact of foreign financial market participation in Hungary, Kenya, and South Africa. Hungary had already a small MNB credit market presence during the socialist regime and it grew rapidly to 32% in 2000. In comparison, Kenya had a historically large presence of MNBs, stemming from its colonial days. The credit market presence of MNBs, though, declined during continued financial fragility and rose again towards the end of the 1990s. During the embargo, South Africa had a very small credit market presence of MNBs that ultimately grew to 4% of the total credit market in 2000.

The Hungarian financial system became majority foreign owned a little over a decade after MNBs were granted entry during the post-socialist regime. The rise of MNBs was helped by a favorable tax treatment, by their high profitability, and by the fact that MNBs were welcome partners in the privatization of formerly state-owned banks. Moreover, domestic banks were ridden with poor capitalizations following poor

management decisions and consequently bad loan portfolios. Bad loan portfolios did not improve quickly enough, although the presence of MNBs offered incentives to domestic banks to improve physical and human capital as MNBs used newer technologies and paid their employees better. As a result, MNBs acquired increasing shares of joint ventures with Hungarian banks, bought privatized banks, and gained control over the majority of the Hungarian banking sector. The rise of MNBs, though, did not improve the credit access to sectors that were traditionally credit constrained, such as small- and medium-sized enterprises (SMEs) because MNBs concentrated on commercial banking, and they expanded into retail banking only gradually over the last few years.

In Kenya, the presence of MNBs was a legacy of the colonial period, but this long-standing, large MNB presence did not help to avoid the financial instabilities of the late 1980s and early 1990s. Undercapitalized domestic banks extended domestic loans often based on political connections of the borrowers, rather than on an assessment of the business opportunities to be financed. The practice of politically determined loans meant that many non-creditworthy borrowers were served by domestic banks, that rigorous credit review standards were not implemented and that the quality of loans continued to deteriorate. The subsequent financial instabilities meant a concentration of credit in the large urban centres, which left many borrowers underserved. Moreover, in a response to rising financial instabilities, MNBs concentrated on the increasingly profitable business of government financing, thereby contributing to the financial constraints of some sectors of the Kenyan economy. MNBs quickly concentrated on lending to the government and to a few of their core borrowers, thereby reducing MNB loans quickly to less than one-fourth, relative to GDP, of what they were in 1985. In addition, financial liberalization (FL) led to rising interest rates, thus shutting good borrowers out.

To address the lack of financing, several micro-finance organizations began to operate in Kenya. Due to its co-operative structures, aid funding, and innovative monitoring approach – credit is given to groups of people who monitor each other – the costs of micro-financing are low and the ratio of non-performing loans are manageable. Overall micro financing provides access to credit to some underserved groups, especially female run businesses, but it is too small to offer a large scale alternative to the fragile and politically determined formal banking sector.

By the mid-1980s, South Africa was the pariah of international banking, as a result of anti-apartheid political campaigning, widespread protests, and the September 1985 default on \$13 billion in foreign debt--along with the imposition of exchange controls. The local representative offices of major international banks closed shop. Yet within a decade of the mid-1980s crisis, the situation had reversed. After the African National Congress (ANC) won the election in April 1994, political stability emerged and wild business cycle swings moderated. Conservative fiscal and monetary policies were adopted, and FL began in earnest. Subsequently, a dozen international banks set up office in South Africa.

The South African experience with MNBs mirrors to some degree that of Kenya. The dependence on MNBs did not help to insulate the economy from the rising financial

fragility and it left many borrowers underserved. Moreover, the link between greater foreign participation in South Africa and financial instability may be more indirect. The increasing presence of MNBs appears to have created a lack of funding for many borrowers who are facing rising costs of capital. Consequently, international financial competition may have lowered investment and growth. Hence, domestic banks turned to international financial market for higher, shorter term, speculative financial investments, such as loans to Russia or Brazil. As a result, the Asian and Russian financial crises easily transmitted to South Africa and led to a rapid currency devaluation, and rising instabilities in the banking sector.

One theme is common to all three countries. The growing presence of MNBs can be linked to a lack of banking services for many borrowers. Especially low and moderate income households and SMEs did not receive adequate funds, thereby facing higher costs of capital. With respect to financial stability, this report's findings are more tentative. There is evidence that banking practices that helped to increase financial fragility continued to thrive in the presence of MNBs in Kenya. Furthermore, MNBs may have had an indirect destabilizing effect on South Africa, as domestic banks, missing strong domestic investment opportunities turned to speculative overseas investments instead.

Consequently, two important public policy goals are not addressed by the growing presence of MNBs in emerging markets. First, the three countries included in this study seem to lack adequate financing for a broad range of sectors. Second, financial stability does not necessarily improve in the face of a growing MNB presence.

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