Available online at www.rajournals.in

RA JOURNAL OF APPLIED RESEARCH

ISSN: 2394-6709

DOI:10.31142/rajar/v5i6.01

Volume: 05 Issue: 06 June-2019

International Open Access

ICV- 74.25

Impact Factor :5.985

Page no.- 2433-2440

Foreign Banks Entry, Banking Sector Performance and Financial Development in Tanzania: Further Evidence

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ARTICLE INFO

Publication Online: 05 June 2019

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ABSTRACT

This paper investigates the effects of foreign banks existence on performance of the banking sector and financial development in Tanzanian during the period 2000 -2016. We hypothesize that foreign banks have had a positive influence on the performance of domestic banks as measured by income and cost indicators.

Further, study findings suggest that increased foreign banks entry is associated with increased financial inclusion since financial liberalization increases as foreign banks set up branches and domestic banks became foreign owned. The econometric results show that foreign bank entry is associated with higher financial inclusion and improved domestic banking sector performance and overall financial development.

KEYWORDS: Tanzania, Banks, Financial Development

1. INTRODUCTION

The banking sector in Tanzania has expanded substantially over the past decade in response to the internationalization of the commercial banking sector which has been facilitated by the liberalization of financial markets worldwide. The government has allowed banks to be foreign owned or operated through foreign and domestic ownership. Such liberalization has proceeded on the premise that the gains to domestic market participants from foreign entry outweigh any losses to domestic banking institutions (Bank of Tanzania, 2007)

Since the 1990s, banking activities in Tanzania have grown fast due to increased globalization of capital markets and liberalization of domestic financial markets. Both cross-border activities and activities of banks outside their home country -foreign banks- have been increasing. In Tanzania, control of the domestic financial market-measured as the ratio of assets of banks where foreigners own more than 50 percent of total equity and total assets of the entire banking sector.

Among other things, these increases in foreign bank control are due to the fact that since 1990 Tanzania has implemented financial liberalization policies, allowing foreign banks to set up branches and domestic banks to be foreign owned. This was stipulated in the bank of Tanzania Act 1991(Bank of Tanzania, 2007, 2015). What we now investigate is what has been the effect of increased foreign banks on the performance of domestic banks and the financial sector large. This is done by use of an econometric analysis based on data for the period 2000 to 2016 with respect to operations of domestic banks and investigates how foreign banks entry may have influenced activities of the financial sector. Our main concern is to analyze the effects of foreign banks entry on the efficiency of the domestic financial system, as measured by financial bank performance indicators. Our study provides further evidence on the effect of foreign banks entry which is an extension of similar studies undertaken in Tanzania these include Kilindo (2009); Mrema (2004); Lotto, (2016); Swai and Mbogela (2014). The paper is an extension of in a way that the time span is longer, 2000 to 2016, and the data base has been updated in that we focus on 60 banks.

Despite some studies showing that foreign bank entry improves the functioning of national banking markets through increased competition and improved efficiency of domestic banks, we further elaborate on these findings by investigating to what extent the effects of foreign bank entry on domestic financial market influence financial development.

The remainder of the paper is organized as follows. Section 2 provides a brief background on foreign banks entry in Tanzania and section 3 presents a survey of literature on the effects of foreign banks entry on the domestic bank market and financial sector. Section 4 presents the methodology by discussing the data and presenting the empirical model. Section 5 presents and discusses the results of the empirical analysis. The sixth section concludes.

2. FINANCIAL LIBERALIZATION AND FOREIGN BANKS ENTRY

Financial sector reforms in Tanzania started in the early 1990s. Prior to that, the financial system comprised of a few public institutions which exercised monopolistic specialization. Basic characteristics of the system was direct monetary via exchange rate setting, direct credit to priority sectors, preferential interest rates, government interference in financial matters and weak supervisory power of the monetary authority.

As a result of the above manifestations, the financial system was weak, characterized by high inflation, negative real interest rates and emergence parallel markets. Later, the government eliminated state controls and introduced market mechanisms in critical areas such as ceilings on government financing, devaluation and elimination of controls in the foreign exchange market.

A move to liberalize the financial sector was taken when a Presidential Commission was established in 1988, which recommended a reform program with a major component being the installation of a new policy environment that was envisaged to facilitate the implementation of the reforms and operation of a new restructured banking system and financial system. As a strategy to accelerate growth, the central bank implemented a series of reforms to promote a market based financial sector.

Table 1: Foreign banks entry and presence trends in Tanzania

year		Number of banks			Bank assets (Tsh. Billion)		
	Foreign	Domestic	Total	Percent Foreign	Domestic	Foreign	Percent Foreign banks assets
2000	13	26	29	44.8	1050	559	65
2001	12	26	28	42.8	1124	659	63
2002	13	28	31	41.9	1378	891	61
2003	13	28	31	41.9	1617	1157	58
2004	14	27	31	45.1	1749	1487	54
2005	14	28	32	43.7	2253	2026	53
2006	14	28	32	43.7	2979	2417	55
2007	17	26	33	51.5	3283	3785	46
2008	19	27	36	52.7	4524	3919	54
2009	20	20	40	50.0	5144	4896	51
2010	21	21	42	50.0	6319	6251	50
2011	24	23	47	51.0	7445	7096	51
2012	25	24	49	51.0	8391	8571	49
2013	27	25	52	51.9	9479	10034	48
2014	28	26	54	51.8	10651	11822	47
2015	29	28	57	49.1	12477	14695	46
2016	30	29	59	50.8	12239	15575	44

Source: Bank of Tanzania (, 2007, 2015)

The Banking and Financial Institutions Act of 1991 paved the way for entrance of private, foreign and domestic investors in the financial sector. The Presidential commission recommendations also resulted in the first generation financial sector reforms. In this reform period emphasis was put on establishing an enabling environment for a free market to operate to provide quality and reliable financial services.

3. LITERATURE REVIEW

As documented in Hermes and Lensink (2002, 2003); Claessens et. al. (2001); Claessens, (2013) and Bruno and Hauswald, (2012), the discussion on effects of foreign banks on the domestic financial markets and institutions has evolved around several issues. For instance IMF(2000); and Harness and Lensink(2002); Wahid(2009); Claessens, (2013); Yesim (2015); and Lotto (2016) focus on issues such as differences in comparative advantages in financial services between countries and the effects of foreign banks entry on the overall stability of the domestic financial system. Lensink and Hermes (2003) on the other hand focus on the arguments that have been forwarded to describe the relationship between foreign banks entry and domestic banks behavior.

The arguments evolve around three areas. Before financial liberalization there was restriction on entry of foreign banks. The policies used to restrict entry reflected hesitant governments to open domestic financial markets to foreign competition. During the 1990s, considerable reduction of restrictions was implemented. In Tanzania this was done under the first and second generation financial sector reforms. This indicated the change of the view of government with respect to the perceived effects of foreign banks on the domestic financial market.

Several studies including Cho (1990); Levine (1996; 1997; 2001); provided the arguments that supported the lifting of the restrictions on foreign banks entry. It is argued that foreign bans presence may stimulate efficiency, and increase the diversity of financial services. The presence of foreign banks puts pressure on domestic banks to improve the quality of their services in a bid to retain their market share. Increased completion leads to lower interest rate margins and profits.

Spill-over effects may be realized due to foreign banks entry. The effects include the new financial services introduced which will be emulated by domestic banks and thus improve financial intermediation, Wahid (2009, Yesim (2015). Foreign banks also introduce modern banking techniques and may help in management of domestic banks in the case of joint ventures or takeovers.

As observed by Bruno and Hauswald, (2012), bank regulation and supervision normally need to be improved due to the presence of foreign banks as improved systems of regulation and supervision would be demanded for the regulatory authorities. For example, in Tanzania the central bank through the Second Generation Financial Reforms emphasized on improvement of bank regulation and supervision.

Quality of human capital in the domestic banking system may increase as foreign banks import high-skilled bank managers and invest in training local employees. These developments improve the efficiency of domestic banks, (Lee et.al.(2012), Gianneti and Ongena, (2009).

There also exists a body of literature that look at the costs and benefits of foreign banks entry. These include World Bank (2000); Claessens et. al., (2001,), Claessens and Lee (2000); Levine, (1996); Claessens and Van Horen (2012), Uiboipin (2005). According to these studies benefits of foreign banks entry include:

(i) Foreign banks improve allocation of credit to the private sector as evaluation and pricing of credit risks becomes more sophisticated

(ii) Foreign banks help build a domestic banking supervision and legal framework and enhance overall transparency

(iii) Foreign banks provide a more stable source of credit as they may refer to their parents for additional funding and have easier access to international funding

(iv) Foreign banks reduce costs of recapitalizing and restructuring of banks

(v) Foreign banks lower the possibility that a country will experience banking crisis by raising efficiency of domestic banks

Foreign banks entry may bring a number of costs to the host economy as pointed out in Hermes and Lensink (2004a, 2004b), Jeon et. al., (2011). It is argued that foreign banks entry increases the likelihood of impairing access to credit for some sector of the economy as foreign banks have different priorities and business focus. Since foreign banks attract the most profitable domestic markets with more advanced services and products, riskier sectors will be served by domestic banks. It has also been argued that foreign banks may increase instability by pulling out of the host country or by contagion from problems in their home countries, Uiboipin (2005).

There are many empirical studies on the effect of foreign banks entry on domestic bank behavior. In Indonesia, Cho (1990), finds that foreign banks presence increased competition. Claessens et. al., (2001) use data from 80 countries for the period 1988-1999 and find out that increased presence of foreign banks is associated with reduction of profitability on interest income and overall expenses of domestic banks.

Country specific studies using the Claessens et. al. (2001) methodology include De Haas and Lelyveld (2014), Brown et.al.(2011), Chopra (2007) whose empirical results show a decline in interest rate margins, returns on assets and overhead expenses of domestic banks after foreign banks entry. Using a similar analytical method as that used by Claessens et.al, op.cit., the Colombian banking system was analyzed by Barjas, and Steiner (2000). The positive influence of foreign banks on the domestic banking sector was supported by the study findings. Y Xu (2011) employed location data of foreign bank branches and provides strong empirical evidence that foreign banks is supportive of a more competitive and efficient banking industry in China. The study shows that foreign banks entry generally increase competition in domestic banking system as measured reduced intermediation spreads. Similar conclusions are arrived at in country studies by Bremus et. al. (2000); Yesim (2015) ; Jeon et. al.(2011); Lee et. al. (2012), Lehner and Schnitzer (2008); Lensink and Naaborg (2007) ; Zajc (2004), and Gormley (2010).

4. METHODOLOGY

4.1 Description of the data

To be able to investigate the effects of foreign banks we have to measure the presence of foreign banks. Following Claessens et. al (2001) and Lensink and Hermes (2003), two different variables are used to measure foreign banks entry. The first is the ratio of the number of foreign banks to the total number of banks in the country, denoted as FBR. This looks at the presence of foreign banks. The second measure is the share of foreign bank assets to total bank assets denoted

as FBAR. This measure takes into account the size of foreign banks as compared to domestic banks. Both variables denoted by FBA and FBAR are calculated based on data from bank of Tanzania, the central bank.

To reflect domestic banks performance we use income, profits and costs of domestic banks. Income of banks is measured by the ratio of net interest margin to total assets, denoted as NIMA and the ratio of non-interest income to total assets, denoted as NNIA.

Profitability of banks is measured by the ratio of before tax profits to total assets, denoted as BTPA. Costs of banks are reflected by the ratio of overhead costs to total assets denoted as OHA, and loan loss provision to total assets, denoted as LLPA.

It is generally agreed in literature that changes in these variables may, among other things, be associated with changes in foreign banks presence through competition and /or efficiency effects (Chopra, (2007); Y- Xu (2011); Claessens, and van Horen (2012); Claessens, (2013); Bayraktar, and Wang (2005); Bruno and Hauswald (2012); Swai, and Mbogela, (2014).

4.2 Hypotheses

As shown in Uiboupin (2005), Hernes and Lensink (2002) and Lensink and Hermes (2003), foreign banks entry is associated with higher bank interest margins. We hypothesize that the net interest margin of domestic banks is positively related with foreign banks entry measures.

It has been indicated in Y Xu (2011), Wahid (2009) and Uiboipin (2005) incomes of domestic banks from lending activities may fall due to increasing competition. The presence of foreign banks increases competition and thus banks try to increase their non-interest income to compensate for the falling interest margin. Non-interest income of the banks may also decrease as they try to offer better conditions and prices for their customers. The final effect of foreign banks entry on non-interest income is ambiguous. The hypothesis turns out to be that the non-interest income of domestic banks is either positively or negatively correlated with the market share of foreign banks.

Claessens et. al. (2001) arrive at the conclusion that higher market share of foreign banks is associated with lower overhead costs, indicating more efficiency. The logic is that domestic banks respond to foreign banks entry with higher overhead costs because they want to keep up their image they improve the technology base in order to be competitive in the market. The adjustment costs incurred when a foreign bank takes over a domestic bank also increase banks overhead costs. The hypothesis is that the overhead costs of domestic banks are positively correlated with foreign banks entry measures.

It is generally agreed that foreign banks entry reduces the profits of the domestic banks. The reason is that foreign banks entry is usually expected to have a positive effect on competition in the banking market and hence have a negative effect on bank profitability. The hypothesis is that the ratio of pre-tax profit to total assets of domestic banks is negatively correlated with foreign banks entry measures, Hermes and Lensink (2003), Claessens et. al. (2001); Claessens (2012).

The correlation of foreign banks entry with bank loan loss provision is ambiguous. This is because foreign banks entry may have both positive and negative effects on loan quality, Uiboipin (2005). The result could be insignificant. The ability to better risk management techniques and methods makes greater foreign ownership negatively correlated with loan loss provision. Due to increasing competition, banks may reduce credit quality in an effort to keep their market share. The hypothesis is that foreign banks entry measures have either a positive or negative correlation with loan loss provision.

Foreign banks entry is expected to have a direct positive impact on furthering financial depth. A combination of macroeconomic and institutional variables such as GDP per capita, inflation, legal creditor rights, private and public credit registries have been associated with financial depth, Djankov et. al.(2007). Foreign banks contribute to reduced costs of financial intermediation resulting in increased credit availability that in turn facilitates overall financial depth in the host country, Claessens et. al.(2001). However, in Claessens and Van Horen (2013) and Detragiache et. al. (2008) it is argued that increased foreign bank presence could lead to lower levels of private sector credit that would in turn result in relatively weaker financial depth. We however hypothesize a positive correlation between financial development and foreign banks entry.

Following Boyd et.al.(2000) we expect inflation to have an adverse impact on financial depth as an increase in the rate of inflation tends to decrease the real rates of return on assets in general. The decrease in rates of return for assets aggravates credit market frictions and leads to credit rationing.

In summary, we test 6 main hypotheses as in Uiboipin(2005). These are:

(i) The net interest margin of domestic banks is negatively correlated with foreign banks presence

(ii) The non-interest income of domestic banks is negatively correlated to foreign banks presence

(iii) The overhead costs of domestic are positively correlated with foreign banks presence

(iv) The ratio of pre-tax profit to total assets of domestic banks is negatively correlated with foreign banks presence

(v) Foreign banks presence has either a positive or negative impact on domestic banks’ loan loss provision.

(vi) Foreign banks entry has positively influenced financial development in the country

4.3 The model

A full model of the determinants of bank performance is needed to enable us examine the relationship between foreign banks entry and performance of domestic banks. The model of Claessens et. al., (2001) has been used most frequently in the studies that investigate the influence of foreign banks entry. We borrow a similar version with the a similar specification. We extend our analysis by investigating the effects of foreign banks entry on domestic banks behavior by estimating a model in which behavior in domestic bank performance indicators are related to foreign bank entry as in Claessens et al., op.cit. Chopra(2009) and Lensink and Hermes(2003) and Bruno and Hauswald (2012).

$\Delta BV = \square + \square\, \Delta FBP + \square \Delta CMV + u$……………………….(1)

Where,

ΔBV= changes in different performance indicators of domestic banks,

ΔFBP = Measures of Foreign banks presence

ΔCMV =country macroeconomic variables (inflation, GDP private sector credit/GDP)

4.4 The econometric model

To estimate the effect of foreign banks entry, we specify a model that links domestic banks performance to foreign bank entry. We have 5 equations that specify domestic bank performance measured as income of domestic banks represented by three indicators. These are as the ratio of interest margin to total assets, the ratio of non-interest income to total assets and the ratio of before-tax profit to total assets. The behavior of these dependent variables is hypothesized to be influenced by foreign banks entry measured as the share of foreign banks in total banks and the share of foreign banks assets to total bank assets. Macro economic variables, inflation, GDP and credit to the private sector as a ratio of GDP are added as control variables.

The two equations thus are:

$$\Delta bi = \beta 0 + \beta 1 \Delta fbp, + \beta 2 \Delta\, dbv + \beta 3 infl, + \beta 4 \Delta GDP, + \beta 5 \Delta credit + u \text{………..(2)}$$

Five specifications of equation 2 were estimated for the five measures of domestic banks performance, ie. NIMA, NNIA, BPTA ,OHA and LLPA as dependent variables. The results are reported as 2(i) to (2v) in Table 2.

We go further to investigate the influence of foreign bank entry on financial development. To measure the level of financial development we use the ratio of credit to the private sector, measured as bank credit to private sector by credit money deposit banks as a ratio of GDP. The model here tries to measure the correlation between financial development *fd,* and foreign bank entry measures *fbar* and *fba*. Inflation *infl*, and the gdp are included as control variables.

$$\Delta fd = f(\Delta fbar, \Delta fba, \Delta infl, \Delta gdp, credit) \text{…………………..(3)}$$

5. ESTIMATION AND DISCUSSION OF RESULTS

Table 2 shows the results of estimating equation one for each of the five domestic banks performance-NIMA, NNIA, BTPA, OHA and LLLPA. There is a clear relationship between foreign bank presence and domestic bank performance. The coefficient on FBA is statistically significant in all the five estimations. Similar results are reported when foreign banks presence is measured by FBAR.

When we look at costs and margins of domestic banks, the negative and statistically significant coefficients support the fact that foreign banks entry is associated with falling costs and margins of domestic banks. For the case of the profit variable, entry of foreign banks contribute more to rising costs than to margins and hence a reduction in profits.

The results of this study are comparable with other studies as presented in Table 3. Foreign bank entry has influenced domestic banks in respective countries differently with most cases reporting positive impact of foreign bank entry on domestic banks performance indicators.

Table 2. Foreign Banks and Domestic Banks: Estimation Results

	Dependent variables	NIMA	NNIA	BTPA	OHA	LLPA	FD
	Specifications of Equation (2) and equation (3)	2(i)	2(ii)	2(iii)	2(iv)	2(v)	(3)
Independent variable							
	FBA	0.003 (3 .123)*	0.002 (4.111)**	-0.033 (-3.071)*	0.005 (1.789)*	0.012 (6.342)***	0.111 (3.324)**
	FBAR	0.001 (2 .123)*	0.011 (3 .102)*	0.000 (1 .123)	0.001 (1 .123)	0.101 (4 .123)*	0.051 (3 .000)**
	infl	-0.235 (0.532)	0.002 (1.386)	-0.000 (2.445)*	-0.006 (2.435)*	0.013 (4.120**)	0.032 (3.901)**
	gdp	0.051 (1.231)	0.071 (0.121)	0.033 (1.101)	0.005 (1.198)	0.034 (1.341)	0.023 (5.11)**
	credit	-0.001 (0.213)	0.000 (2.113)*	0.081 1.901)	0.007 (1.456)	0.000 (1.011)	-
R-Squared		0.831	0.423	0.345	0.511	o.602	0.701

Notes: *, **, and *** denotes significance at the 10, 5 and 1 percent level respectively

Financial development as measured by the ratio of credit to the private sector to gross domestic product show a positive relationship with foreign bank entry indicating that entry of foreign banks have increased as financial sector performance improved. The influence of inflation on domestic banks performance is negative as hypothesized

while GDP has a positive and significant relationship with domestic banks performance indicators. Most of the coefficients are not significant at conventional levels though reflecting low the influence they have on bank performance.

Table 3. Results of hypotheses tests and explanation

Hypothesis	Expected sign	Actual sign	Explanation
The net interest margin /assets	positive	positive	Interest margins have increased
Non-interest income /assets	Positive or negative	positive	Domestic banks have increased non-interest income
Before-tax profit/assets	negative	negative	Increased competition in the banking sector has reduced profits of domestic banks
Overheads /assets	positive	positive	The take-over of domestic banks by foreign banks has increased worker quality and modern technology use and thus increased overheads
Loan-loss provision/assets	Positive or negative	positive	Domestic banks have reduced credit quality to keep market share and thus increased loan-loss provision

Source: Uiboipin (2005)

In Table 4, we summarize the results of similar analyses elsewhere. It is seen that the results have varying signs as other similar studies employing the model as in Claessens et. al.(2001). As pointed out earlier the influence of foreign banks entry on domestic banks will depend on the competition level, risk management techniques and overhead costs adjustment on the part of domestic banks.

Table 4. A Summary of Results and Comparison with Earlier Studies

author	model	Non-interest income	Net interest margin	Before-tax profit	overheads	Loan-loss provision
Uiboipin (2005)	FBSN FSA FBSN*DCGDP	- - +	NS NS NS	NS NS NS	NS + -	- + NS
Claessens et.al(2001)	FBSN FSA	NS NS	- NS	- NS	- NS	NS NS
Hernes and Lensink(2002)	FBSN FBSN*DCGDP	+ -	+ -	+ -	+ -	+ -
Lensink and Hernes (2003)	FBSN FBSN*DCGDP FSA FAS*GDPPP	+ - + -	+ - + -	+ - + -	+ - + NS	+ - + -
Bayraktar and. Wang (2005)	FBSN FSA	NS -	NS -	- -	+ +	NS NS
Kilindo (2009)	FBS FBSA	+ -	+ +	- +	+ -	+ +
Current study	FBR FBAR	+ +	+ +	- +	+ +	+ +

Notes: "+" indicates a significant positive correlation and " –" indicates a significant negative correlation

Source: Uiboipin (2005); Kilindo (2009)

6. CONCLUSION

The paper investigated the relationship between foreign banks entry and domestic banks performance and financial development in general. Building on a model based on Claessens et. a., (2001) and later applied also by Lensink and Naaborg (2007) and Bruno and Hauswald (2012). The regression results show that foreign banks entry is significantly associated with domestic banks' performance and efficiency indicators and also financial development. Domestic banks income indicators, non-interest income over

assets, interest margin over assets and before tax profit over assets are significantly related to foreign bank entry. Further, cost indicators of domestic banks, loan loss provision over assets and overhead costs over assets are both influenced by foreign banks presence. The signs of the coefficients on cost and profit indicators appear to be as hypothesized; indicating that foreign banks entry has brought a more competitive environment in the banking sector. Moreover, foreign banks entry is significantly related o financial development as measured by the ratio of private credit to GDP.

The study findings suggest that foreign banks entry has generally improved domestic banks performance and financial development in general. These findings are in support of government policy to open up the financial sector to foreign banks. This is because Tanzania is not fully liberalized and therefore has the chance to continue internalizing the banking sector while learning by doing from foreign banks entry.

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