Globalization in an Emerging Economy: The Impact of Foreign Bank Entry into South Africa

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Background

Following amendments to the South African Bank Act in 1994 foreign bank branches, representative offices and subsidiaries entered the South African financial market. Many of these banks had previous connections with South Africa, some remained active during sanctions, some left and have now returned while the majority entered the market for the first time.

This paper looks at the structure of the financial market, and based on empirical research, details the foreign banks methods of entry, their target markets, and their success to date in penetrating the market. In particular it discusses the challenges of banking in this unique emerging financial market that embraces both first world and third world characteristics.

South Africa in contrast to most emerging market economies has a well-developed financial system, which includes several different types of banks - commercial banks, merchant banks and general banks. No formal distinction exists between each type of bank and the activities of each class often overlap. Its central bank - the South African Reserve Bank is one of the oldest central banks outside of Europe. It was established in 1921, and has played a major part the development of the country since that time

The financial system is highly concentrated and has similarities to the U.K., Canada and Australia. At the end of 1994 the four largest banks, ABSA, Standard Bank, First National Bank and Nedcor accounted for 80 percent of the banking systems' assets and 82 percent of its deposits. However partly as a result of the foreign bank entry and the growth of smaller domestic banks such as Investec and Rand Merchant Bank the four largest banks have experienced erosion in market share. As a result by the end of 1997, their assets and deposits represented 75 percent and 76 percent respectively of the overall banking system.

It is estimated that around 80 foreign banks now have a presence in the South African market, (see appendix). In addition, a number of foreign investment banks based in New York, London and elsewhere are active in the marketplace. These banks may in time open offices in South Africa.

Foreign Bank Regulation

Foreign bank branches are subject to virtually all the regulations, including reporting procedures, which apply to locally registered banking companies. Branches must maintain a minimum "Endowment Capital" of the greater of R50 million and 8% of risk weighted assets as calculated for locally registered banking companies. Foreign banks with net assets greater than US$1 billion and an investment grade rating from an international rating agency may apply to form a local banking branch. The application procedures to be followed are similar to those of full banking subsidiaries.

To establish a representative office in South Africa the foreign banks must first, under the terms of the Banks Act, obtain the written consent of the Registrar of Banks. A representative office is not permitted to engage in banking activities such as accepting deposits.

Unique Characteristics of the South African Economy

In the 1970's and 1980's South Africa suffered from punitive economic sanctions which included trade boycotts, withdrawal of foreign loan funds and active disinvestment campaigns. Foreign banks such as Barclays Bank, which had an extensive retail banking franchise, literally disappeared overnight from the financial landscape.

These international sanctions were removed following the democratic elections of 1994 and as a result economic opportunities opened up for South Africa to re-integrate its economy once again into the global environment.

The democratization process, resulted in the African National Congress (ANC) government being elected in April 1994 with a 64 percent majority. (It was subsequently re-elected in June 1999 with an increased majority). The new government responded to the urgent needs for better housing, education, health care and other basic services by introducing a comprehensive program for Reconstruction and Development (the RDP).

In June 1996 the ANC government produced a macroeconomic strategy for growth, employment and redistribution [G. E. A. R.], which concentrated more on the supply side of the economy. This analysis identified barriers to the economic growth potential of the country and provided some indication of how the government planned to accomplish RDP objectives over time. The manufacturing sector is the single largest contributor to GDP (approximately 23%), followed by financial services (16%) and trade sector (15%).

As noted later South Africa has a sound domestic banking system that contrasts dramatically with many other emerging market economies. However the unique characteristics of the South African economy means that both the domestic banks and the new foreign bank entrants have a vital role to play in attempting to overcome the challenges faced in the re-integrating South Africa into the global economy and at the same time assisting in the development and corporate unbundling of the domestic economic environment.

Reintegration of the South African Economy into the World Economy

In the past five years South Africa has had to face the challenge of rejoining the world economy at a time when the global financial markets were in a process of major change. The globalization process has therefore required South Africa to make a number of concurrent, radical changes to its financial system.

It has been forced to liberalize its domestic banking sector, re-admit new foreign competitors, develop domestic financial markets, including the market for foreign exchange, and to upgrade the national payment, clearing and settlement systems. All of these changes have had to occur in a very short time period.

A number of steps in the process of reintegration into the world financial markets have required a cautious, measured approach. For example exchange controls that were introduced in 1961 have been gradually relaxed. Today it is estimated that South Africa has removed about 75 percent of the exchange controls that existed at the time of democratization.

Furthermore integration into the world financial markets has also required a major restructuring in the South African capital markets. In 1996 the Johannesburg Stock Exchange [J. S. E.] introduced major reforms to provide for corporate ownership, foreign ownership [of stockbrokers], dual capacity trading, negotiated commissions, and electronic screen trading.

In addition significant increases in volumes on the bond exchange have occurred over the last few years the relaxation of South African exchange controls made an important contribution to the development of the bond exchange. Interest has also expanded in the South African Futures Exchange [S. A. F. E. X.]. There are now plans to converge the three exchanges, the J. S. E., Bond Exchange and SAFEX into one entity.

Economic Implications of the Globalization Process

The Reserve Bank of South Africa has pointed out that the process of globalization has resulted in both advantages and disadvantages to the economy. One of the major advantages is that scarce sources of finance for economic development can be supplemented with increasing amounts of foreign funds. As result savings from developed countries can be transferred to South Africa to supplement a very low level of domestic saving.[1]

However globalization can also have negative impact. For example the exchange rate of the Rand is now more subject to the whims of foreign investors, as well as to developments in the foreign exchange markets of other countries. The sudden inflow of funds from outside could result in a decline in South African interest rates. Similarly an outflow of funds as result of developments in another country such as Indonesia could lead to an increase in South African interest rates. Share prices on the J.S.E. are also now more critically affected by the behavior of foreign investors.

The internationalization of South Africa's banking system has exposed it to increased contagion from foreign counterparts. At the commencement of the Asian crisis in mid-1997, South Africa considered itself to be much less vulnerable than other emerging markets. The local economy at that time was relatively robust and South Africa thought it would successfully weather the crisis. However negative market developments in places such as Brazil and Russia lead to a contraction in global credit spreads and the highly liquid South African bond market was unable to avoid the subsequent foreign sell off.

Market Share of Foreign Banks in Emerging Markets

Before looking specifically at South Africa it is valuable to point out that foreign banks tend to pursue niche strategies and as a result often make up a relatively small share of the overall banking market.

Unless they are able to acquire local banks [and this is sometimes either not possible or not desirable], foreign banks tend to be restricted to less than 10 percent of the overall market.

The table below shows that in the emerging markets such as Argentina and Chile where acquisitions have been possible foreign bank market share is around 20 percent, but in most markets it resides below 10 percent.

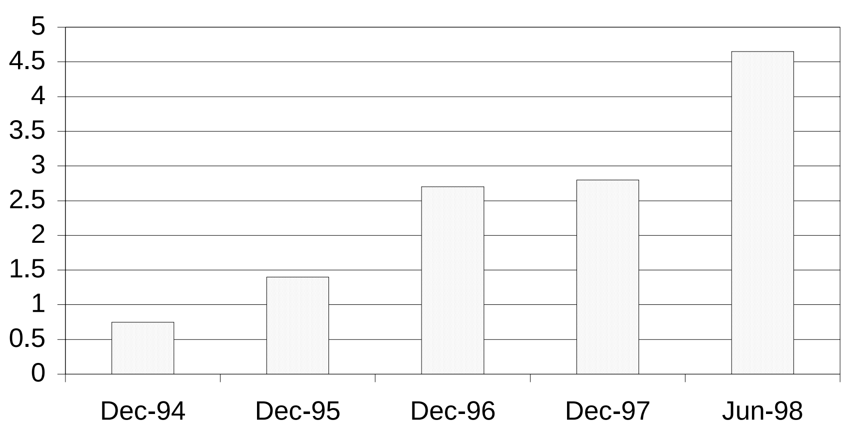
Foreign-owned Banks Percentage Share of Total Assets

Argentina	21.7
Chile	21.4
Malaysia	15.9
Brazil	9.4
India	7.3
Thailand	7.1
Korea	5.1
Taiwan	4.7
Indonesia	3.7
Columbia	3.6
Russian Federation	2.2
Mexico	1.2
Venezuela	1.2

Sources: Central Banks and Ministries of Finance.

Foreign banks in South Africa have been able to make significant increases in market share since 1994 but they still possess less than five percent of the overall market.

Growth in Market Share of Foreign Banks in South Africa



Source: ABN AMRO, Johannesburg

The Importance of a Sound Banking System in an Emerging Market

The structure and efficient management of the South African domestic banking sector will continue to play a significant role in this emerging market economy. The soundness of the financial system has meant that South Africa has not suffered the same way as many other emerging markets.

Domestic banks in South Africa are well capitalized and the average risk weighted capital adequacy ratio for the system as a whole reached 9.9 percent at the end of 1997. Thirty-one banks had a capital adequacy ratio of 11 percent or better in 1997. Furthermore South African banks have sophisticated risk management systems and effective corporate governance schemes in place.[2]

All of these factors mean that South Africa contrasts dramatically with other emerging markets particularly those in Asia where banking instability has contributed to the recent economic crisis. The importance of a stable banking system to an emerging market is clearly illustrated by research undertaken by Caprio and Klingebiel who have identified a number of emerging markets in which losses or resolution costs have exceeded more than 10 percent of GDP.[3]

Banking crises in developing countries have been far more severe during the past 15 years than those in industrial countries.[4]

Impact of Banking Crises on GDP in Emerging Markets

	Losses as a % of GDP
Argentina	25+
Chile	25+
Ivory Coast	25+
Venezuela	18
Bulgaria	14
Mexico	12-15
Hungary	10

Source: Caprio and Klingebiel (1996)

Research Methodology

This research looks at the entrance of foreign banks into the South African financial system. It is based on personal interviews conducted with senior management of 28 foreign banks in Johannesburg in May 1998. The list of participants was carefully selected to ensure comprehensive representation of the growing foreign bank presence. As noted earlier or a list of all foreign banks in South Africa is recorded in the appendix.

The banks interviewed were assigned to the following groups: American, British, Dutch, French, German, Japanese, Swiss, and Other Banks. These groups are used to protect the confidentiality of data supplied by individual banks. It would not be possible to conduct this type of survey by revealing individual responses.

Members of the Different Bank Groups

American Banks
Bank of America
Chase Manhattan Bank
Citibank
First Union National Bank of Carolina
Bankers Trust
J.P. Morgan

German Banks
Commerzbank AG
Deutsche Bank AG
Dresdner Bank AG
DG Bank AG

Dutch Banks
ABN AMRO Bank NV
ING Bank
Rabobank

Japanese Banks
Bank of Tokyo-Mitsubishi
Sumitomo Bank

British Banks
Barclays Bank of South Africa
Robert Fleming
Standard Chartered Bank

French Banks
Crédit Agricole Indosuez
Crédit Lyonnais
Société Générale - South Africa
Banque Nationale de Paris

Swiss Banks
Credit Suisse First Boston
UBS AG

Other Banks
International Bank of Southern Africa
Royal Bank of Canada
Korea Exchange Bank
Nordbanken

Legal Status of Group in terms of Branches and Representative Offices

Representative Offices
Bank of America
Bank of Tokyo-Mitsubishi
Bankers Trust
Banque Nationale de Paris
Chase Manhattan Bank
Crédit Lyonnais
Credit Suisse First Boston
Deutsche Bank AG
DG Bank AG
Dresdner Bank AG
First Union Bank of Carolina
Korea Exchange Bank
Nordbanken
Rabobank
Robert Fleming (SA) (Pty) Ltd
Royal Bank of Canada
Standard Chartered Bank
Sumitomo Bank
UBS AG

Branches and Subsidiaries
ABN Amro Bank NV
Crédit Agricole Indosuez
Barclays Bank of South Africa
Citibank
Commerzbank AG
ING Bank
International Bank of Southern Africa
Société Générale - South Africa
J.P. Morgan

Market Penetration and the Success of Foreign Banks

To discover the degree of success the foreign banks have had so far in penetrating the different sectors of the banking market they were asked to score each of the following factors on a scale 1 to 5 (where 1 is very unsuccessful and 5 is very successful):

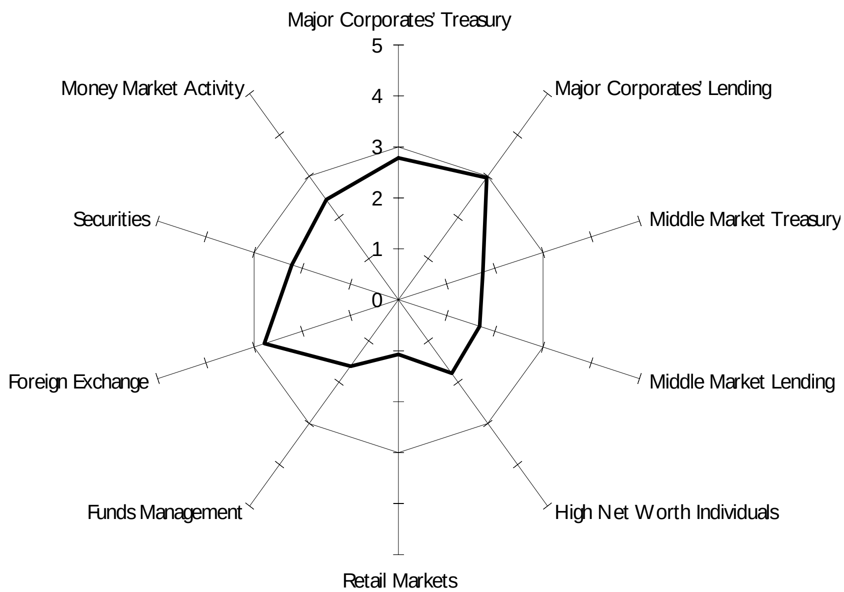
- Major Corporates' Treasury
- Major Corporates' Lending
- Middle Market Treasury
- Middle Market Lending
- High Net Worth Individuals
- Retail Markets
- Funds Management
- Foreign Exchange
- Money Market
- Securities

Since 3 is perceived as neutral to suggest any degree of success average figures for the bank groups should exceed 3. In the radar diagrams produced in the following pages, a ten-sided frame, based on the value of 3 was drawn.

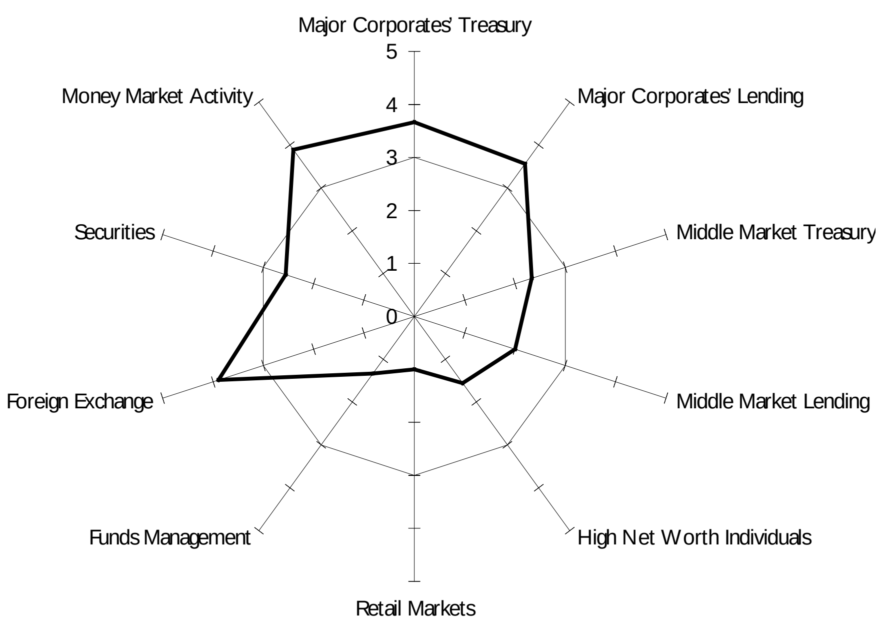
This means that if the bank group falls inside any one of the ten marked areas then it has not successfully penetrated the market. If on the other hand it breaks through the boundary it can be considered to be successful.

All Banks
Based on the responses of all 28 banks interviewed the group as a whole does not believe it has been successful in any one of the ten markets mentioned. This suggests that banks are pursuing different strategies and there is in effect a degree of self-cancellation of individual bank scores. This portrayal however changes when individual bank groups are examined.

The very low score attached to retail banking manifests itself in each of the subsequent bank group charts. It confirms that foreign banks have little interest in the retail banking sector and instead tend to focus their efforts on specialized market niches. In the areas of Foreign Exchange, Money Market and Major Corporate Treasury and Major Corporate Lending the banks come close to breaking the success barrier.

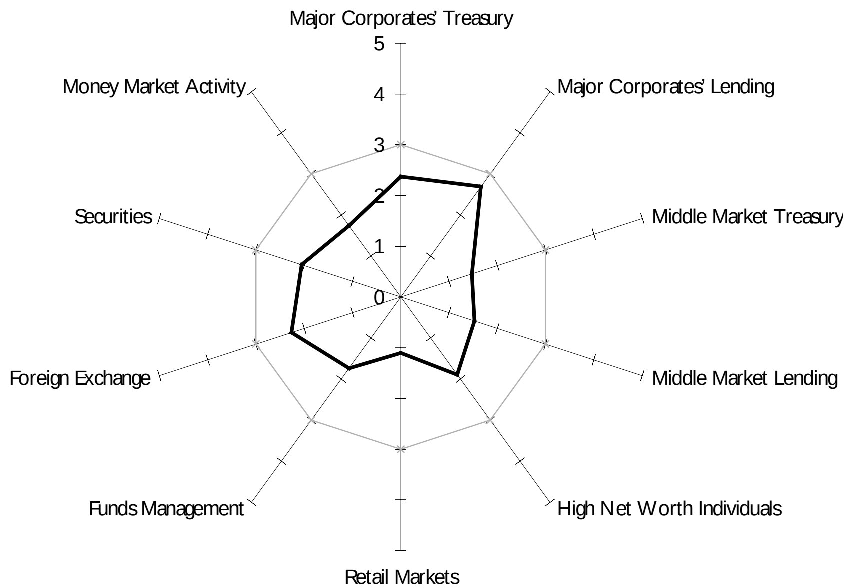


Branches
The branches consider themselves successful in four segments, Major Corporates, Treasury and Lending, Money Market and Foreign Exchange.



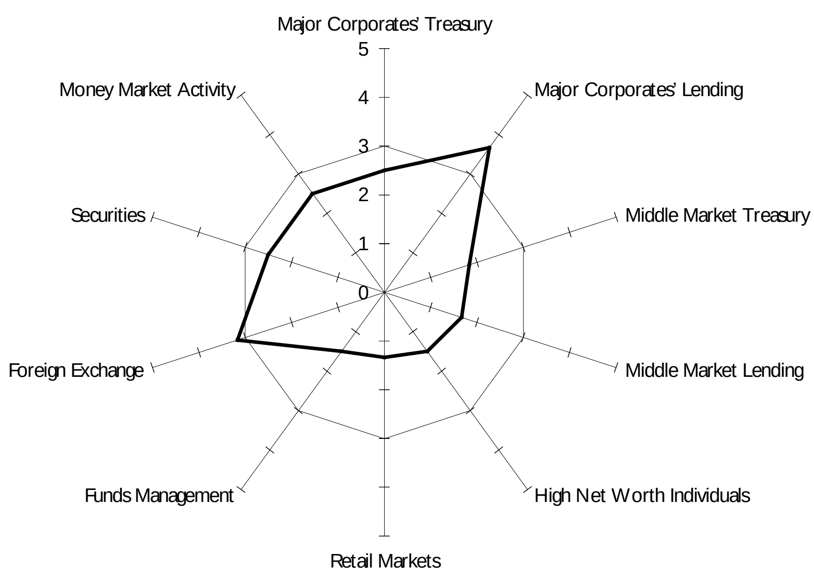
Representative Offices

The 19 representative offices in this research are collectively unable to break out of the 3 point average in any single market. In Major Corporates' Lending they came close to scoring 3.0. However as representative offices they are less actively engaged in the market and therefore indicate a much less successful pattern than the branches.

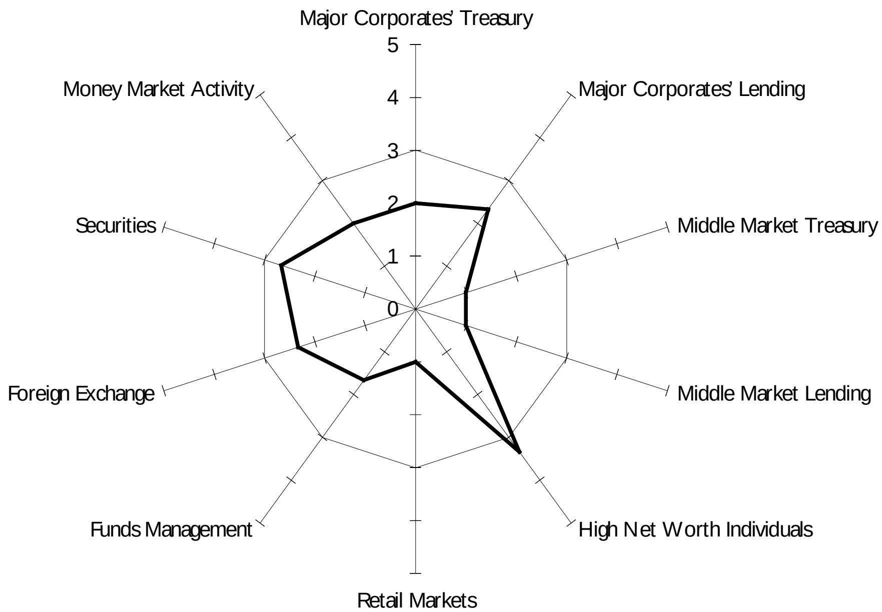


American Banks

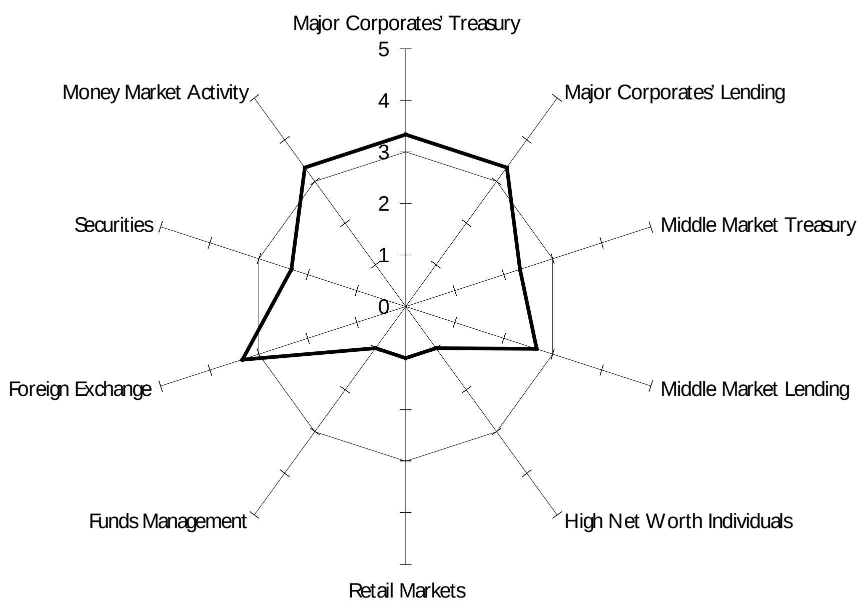
The American banks recorded their most positive score in relation to Major Corporates' Lending followed by foreign exchange.



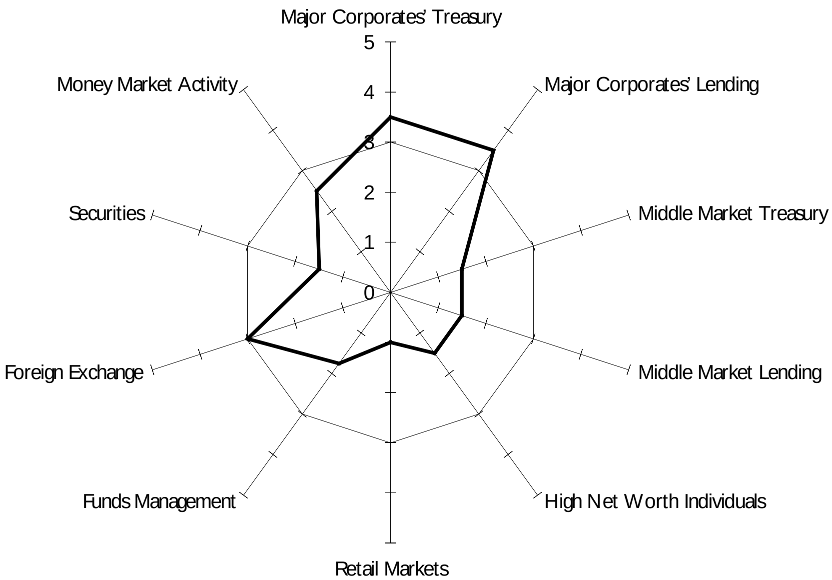
British Banks
The British banks attribute greatest success to high net worth individuals and have only modest scores in other areas.



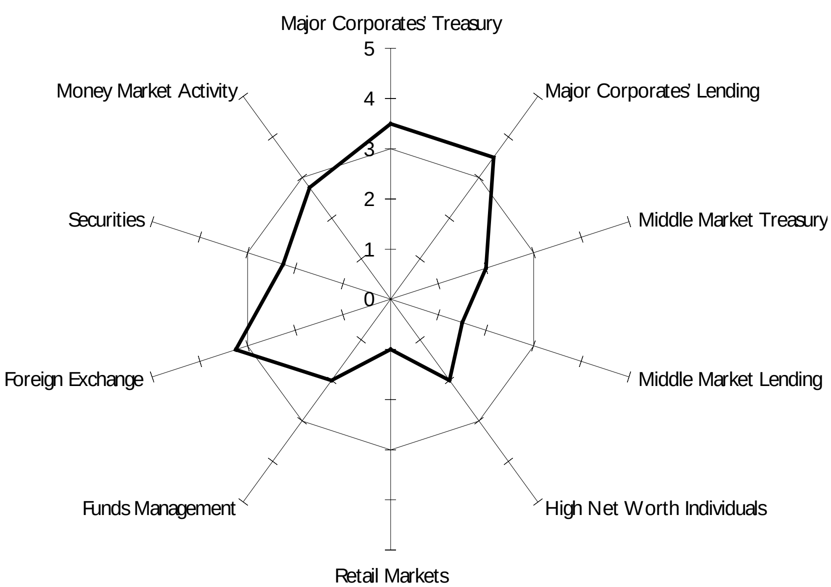
Dutch Banks
The Dutch banks remain outside the web in four areas with the Major Corporates' Lending and Treasury, Money Market and Foreign Exchange. Two of the Dutch banks, ABN AMRO and ING Barings have aggressively attacked the market and are active in a number of different segments.



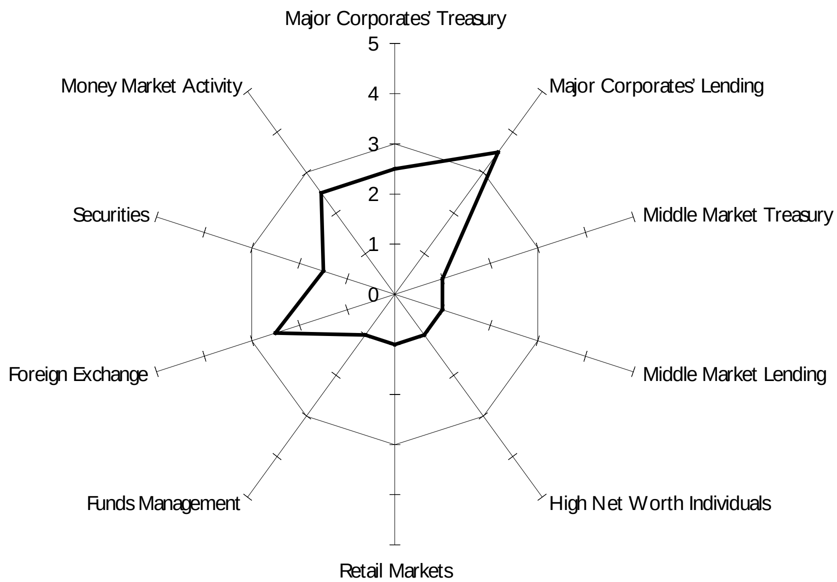
French Banks
The French banks have positive scores in Major Corporates' Lending and Treasury. One of their group, Credit Agricole in its previous form as Banque Indosuez, remained active in the market during the period of isolation and therefore has been able to benefit from its significant critical mass in the new market environment.



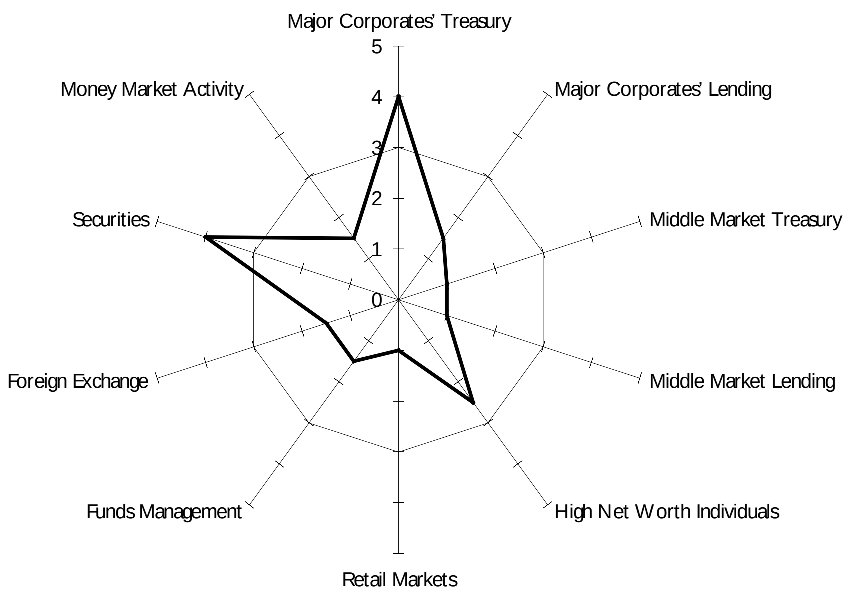
German Banks
The German banks assign most success in the Major Corporates' Lending, Treasury and Foreign Exchange markets. They have low scores in the Middle Markets.



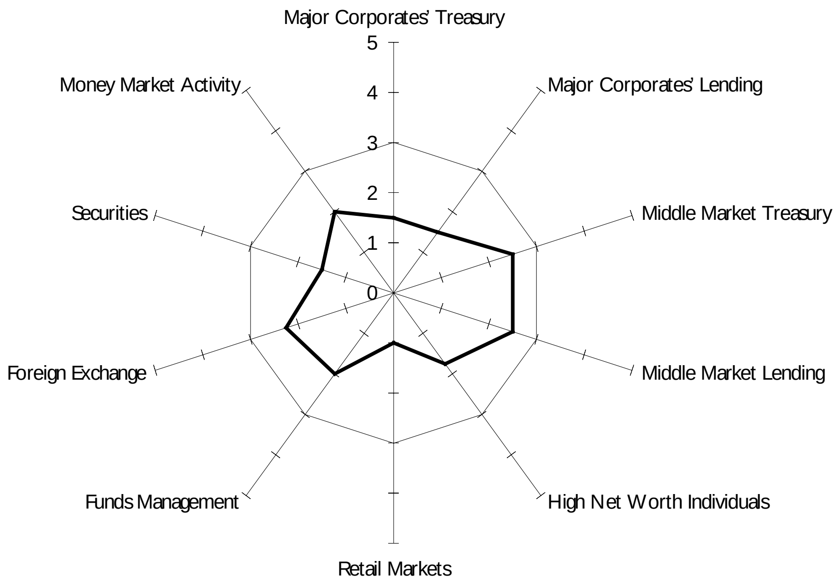
Japanese Banks
The Japanese banks have attached greatest importance to Foreign Exchange and Major Corporates' Lending.



Swiss Banks
The Swiss banks recorded their highest scores in two markets in relation to Securities and Major Corporates' Lending. They attach little importance to the other eight segments.



Other Banks
The disappointing scores in this group continue to reflect some members' diverse backgrounds and ability to neutralize scores.



Most Important Market Segments over the Next Five Years

To examine the "Where Next?" in terms of market segments, the 28 participating banks were asked to rank in order of 1 to 5 the following bank markets, where 5 is very important and 1 least important.

- Top 100
- Middle Market
- High Net Worth Individuals
- Retail Banking
- Funds Management
- International Banking
- Corporate Advisory Services
- Securitization of Debt
- Treasury
- Securities
- Privatization

As stated earlier any score below 84 (that is 28 banks x 3) indicates that the banks have little interest in this area.

Most Important Segments Index

	1998
Top 100 companies	116
International Banking Services /Trade Finance	111
Corporate Advisory Services	100
Treasury	95
Securitization of Banking Debt	87
Privatisation	82
Securities	79
Middle Market	77
High Net Worth Individuals	77
Funds Management	77
Retail Banking	31

Top 100 Companies has replaced International Banking Services, including Trade Finance, as the key target market for foreign banks.

These markets are followed by Corporate Advisory Services, Treasury, and Securitization of Banking Debt. Privatization, often an important issue in emerging markets, falls into sixth place.

Six segments fell below the critical 84 level. These included:

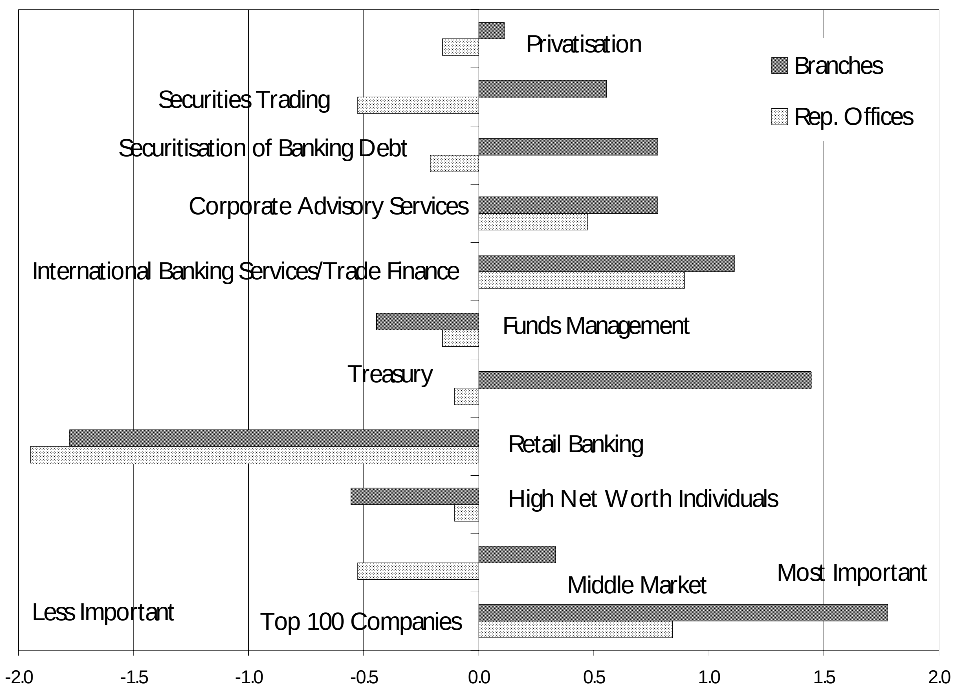
- Privatization
- Securities
- Middle Market
- High Net Worth Individuals
- Funds Management, and
- Retail Banking

Although 84 represents a threshold level, a number of banks continue to have a strong interest in the development of a Debt Securitization market, which when it becomes available will represent an important evolutionary step.

Since 3 is perceived as neutral, for a market segment to be considered important average figures for the groups should exceed 3. In the diagrams that follow 3 is equivalent to 0, and bars on either side of the 0 axis reflect their deviation away from 3 either negatively or positively. Consequently, a +2 score for a bar represents an average +5 (i.e. very important) score for the group.

Representative Offices and Branches

The Representative Offices and Branches have contrasting degrees of interest in different market segments. As expected Securities Trading, Securitisation of Banking Debt, Treasury, Middle Market and Privatisation are of particular interest to the Branches. Both are interested in the Top 100 Companies, International Banking Services and Corporate Advisory Services.



Privatization

Privatization shows that three groups have recorded strong interest. They are the Swiss, German and Japanese banks. The American, French and Dutch banks are however neutral. Several banks commented that Privatization has been slower to occur than originally expected. This reflects the degree of frustration of dealing in an emerging market where Government's stated intentions are not realized in the projected timeframe.

In addition, they felt that the introduction of three black empowerment banks would reduce the opportunities for the foreign banks in this area.

Conclusion

Stanley Fisher concluded in his analysis of the financial crisis in emerging markets that, "globalization is here to stay". He described globalization as an approach to economic management based on openness and increasing integration with the rest of the world and on vigorous structural reforms aimed at strengthening the economy and market forces.[5]

Furthermore Patrick Honohan has noted that technological and financial market change has been an underlying factor in increasing competitive pressures by undermining the dominant position of local banks and an opening up of new and untested areas of operation.[6]

All of these issues have particular relevance to the entry of foreign banks into the South African market since 1994.

As noted South Africa contrasts with other emerging markets because of its sound banking system and its respected and capable Reserve Bank. However it has not been able to escape some of the negative forces associated with emerging markets. The Asian contagion has caused increased volatility in the South African financial market.

The entrance of the foreign banks has illustrated the openness of the banking system and this empirical research has identified the markets that these players have targeted and the segments in which they have greatest interest over the next five years.

The foreign banks have brought important innovations to the marketplace both in terms of new products and wider access to global markets. They have not only contributed to, but accelerated the globalization of this unique emerging market.

Globalization is also relevant in terms of South Africa's financial responsibilities in other African countries. In 1995 South Africa signed a formal treaty for economic cooperation in Southern Africa between 12 countries. This treaty referred to as the Southern Africa Development Community [S. A. D. C.], provides for economic cooperation and, eventually, integration in the region. Globalization forces first experienced in South Africa will therefore also trickle down to other sub Sahara markets.

In conclusion, the stable domestic banking system has benefited from the entrance of new foreign banks into the market. While it is clear that these new entrants have distinct targets, they have increased the level of competition and this has benefitted the corporate market. To date they have shown no interest in the retail banking sector.

The foreign banks have also provided a unique window on global markets that the domestic banks with their limited international networks are unable to provide. The impact of foreign banks over the last five years has been considerable and has provided a very real and meaningful form of globalization in this unique emerging market.

Appendices

Branches and Subsidiaries of Foreign Banks in South Africa, May 1999

Branches

ABN AMRO Bank N.V.
Bank of Baroda
Barclays Bank Plc, South Africa Branch
Citibank N.A.
Commerzbank Aktiengesellschaft
Credit Agricole Indosuez
Deutsche Bank AG
ING Bank N.V. South Africa Branch
Merrill Lynch Capital Markets Bank Limited
Société Générale
Morgan Guaranty Trust Company of New York
State Bank of India

Subsidiaries

Albaraka Bank Limited
Bank of Taiwan (South Africa) Limited
Habib Overseas Bank Limited
HBZ Bank Limited
International Bank of Southern Africa Limited
Islamic Bank Limited (In Final Liquidation)
New Republic Bank Limited
Southern Bank of Africa Limited
TA Bank of South Africa Limited
The South African Bank of Athens Limited

Representative Offices of Foreign Banks in South Africa, May 1999

American Express Bank Limited
Banca di Roma
Banco BPI, SA
Banco Comercial Português
Banco Espirito Santo e Comercial de Lisboa
Banco Português do Atlántico SA
Banco Santander
Banco Santander Portugal, SA
Banco Totta & Açores SA
Bank Creditanstalt International AG
Bank Leumi Le-Israel BM
Bank of America National Trust & Savings Association
Bank of Cyprus Group
Bankers Trust Company
Banque Belge (Guernsey) Limited
Banque Bruxelles Lambert s.a.
Banque Commerciale Zairoïse
Banque De Gestion Edmond De Rothschild Luxembourg
Banque Nationale de Paris
Banque Paribas
Bayerische Hypo- und Vereinsbank Aktiengesellschaft
Bayerische Landesbank Girozentrale
Belgolaise Bank
Berliner Handels- und Frankfurter Bank
China Everbright Bank, South African Representative Office
Commerzbank AG
Compagnie Financière de CIC et de l'Union Européenne
Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank Nederland)
Credit Commercial de France
Crédit Lyonnais
Credit Suisse First Boston
Deutsche Bank AG
DG Bank Deutsche Genossenschaftsbank
Dresdner Bank AG (Dresdner Kleinwort Benson)
Export-Import Bank of India
First Union National Bank of Carolina
Hambros Bank Limited
Hellenic Bank Limited
HSBC Equator Bank Plc
KBC Bank NV
Kleinwort Benson Ltd (Dresdner Kleinwort Benson)
Kredietbank SA Luxembourgeoise
MeesPierson NV
Merita Bank Plc

Natexis Banque
National Bank of Egypt
National Bank of Malawi
Nordbanken AB
Royal Bank of Canada
Société Générale - South Africa
Standard Chartered Bank
The Bank of Tokyo-Mitsubishi, Ltd
The Chase Manhattan Bank
The Cyprus Popular Bank Limited
The Rep. Off. for Southern and Eastern Africa of
The Export-Import Bank of China
The Sumitomo Bank Limited
UBS AG
Union Bank of Nigeria Plc
Vereins- und Westbank AG
West Merchant Bank Limited

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