

**The role of foreign banks in the  
Central Asian transition  
economies:  
The implications for the banking  
sector stability**



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# Introduction

- Transition economies have relatively undeveloped equity market, the role of banks as provider of credits to local enterprises is seen as the major financial source;
- The recent years have been characterized with the significant restructuring and consolidation in the banking sector of all transition economies which was undertaken through privatization of state-owned banks (SOBs) and opening up the banking sector to foreign investors and multinational banks (MNBs);
- The region of Central Asia with its five transition economies as Kazakhstan, Uzbekistan, Turkmenistan, Kyrgystan and Tajikistan have not been researched in-depth, thus this paper tries to shed a light on the progress that Central Asian republics (CARs) made in attracting foreign banks into their banking sector.

# Profit function of domestic and foreign banks in transition economies of CARs

*The profit function of typical bank "a" in CARs will be:*

$$\pi_a = r_a^l L_a - r_a^d D_a + r_a^n N_a - R(L_a + N_a - E_a - D_a) - C(D_a, N_a, L_a)$$

*Where,*

$\pi_a$  - *profit function of bank "a";*

$r_a^l L_a$  - *interest ( $r_a^l$ ) earned on loans ( $L_a$ ) provided by bank "a";*

$r_a^d D_a$  - *interest paid ( $r_a^d$ ) on deposits ( $D_a$ ) received by bank "a";*

$r_a^n N_a$  - *interest ( $r_a^n$ ) received from other investments ( $N_a$ ) (these investment might vary depending on sophistication) by bank "a";*

$R$  - *inter-bank rate;*

$(L_a + N_a - E_a - D_a)$  - *net debtor position of the bank "a" in the inter-bank market;*

$C(D_a, L_a, N_a)$  - *represents cost of management's decision making and information processing capability of bank. "a".*

# Profit function of domestic and foreign banks in transition economies of CARs

Ceteris paribus, bank on the microeconomic level can be viewed from two perspectives - *information processing capability* -  $C(D_a, L_a, N_a)$  and *the level of bank product sophistication* -  $L_a$  and  $N_a$ .

- The bank should be effective in gathering and processing information in a way that reduces problems associated with adverse selection and moral hazard in its lending decisions. In general it means that banks must be able to collect and process information about the economy and specific enterprise in such a manner that provides appropriate decision making on how the lending to particular entity might effect on the profitability and risk of bank, so if the bank has a better information processing capability the greater will be its ability to overcome bad borrowers and eliminate excessive risk-taking and vice-versa;
- The products provided by the banks in transition economy might vary in sophistication;
- The more sophisticated product is the higher rate of return the product will generate to the bank as the bank will take on additional risk for which it will require additional compensation (*risk-return tradeoff*), thus, *ceteris paribus*, it will be in the best interest of bank to provide more sophisticated product as this generates higher return.

# Profit function of domestic and foreign banks in transition economies of CARs

The typical foreign bank (a) in the CARs will have a high information processing capability as these banks possess high skilled employees which have an expertise in screening profitability and risk of project and better information technologies to store, process and evaluate data which in its turn secures foreign banks from "unreasonable risk" -

$$\downarrow C(D_a, L_a, N_a).$$

At the same time foreign bank has more sophisticated products in its portfolio as this bank has set of products innovated in home country which it will find relatively easier to introduce such products in the local market, thus the foreign banks are more active in providing sophisticated products with higher rates of return ( $\uparrow r_a^l L_a$  and  $\uparrow r_a^n N_a$ )

While the typical domestic bank (b) will have inappropriate information processing capability as this bank does not possess high skilled employees and sophisticated information technologies, thus domestic banks will face higher "unreasonable risk" -  $\uparrow C(D_b, L_b, N_b)$ , which forces domestic banks to have less sophisticated products in their portfolios generating lower rates of return ( $\downarrow r_b^l L_b$  and  $\downarrow r_b^n N_b$ ).

# Positive effects of foreign banks' entry on the Central Asian market stability

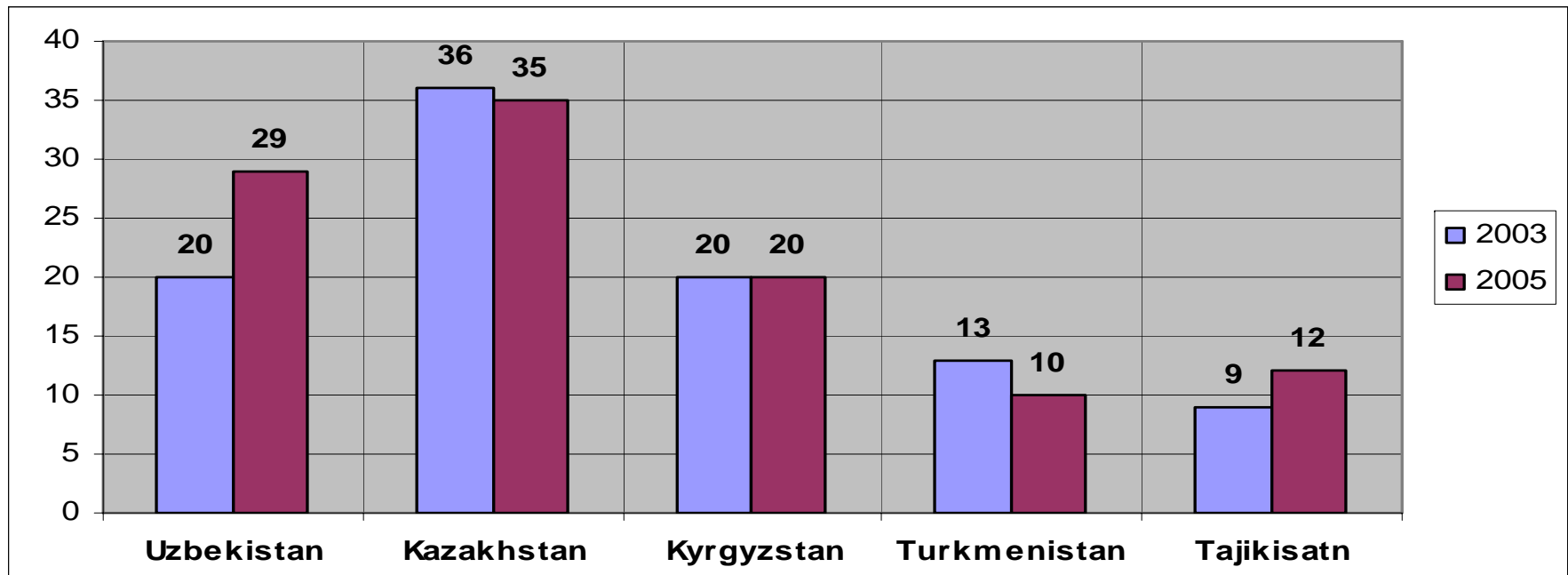
- Foreign banks can provide a more stable source of credit;
- The international diversification of foreign banks has a positive effect on the ability of foreign banks in providing credit funds to the enterprises in the host country when the macroeconomic condition in the host country is not favorable;
- Foreign banks might increase the stability of the host market by transferring good banking practices (*spillover effect*);
- Foreign banks maintain more conservative credit policy in contrast with the domestic banks;
- "Flight to quality" plays a crucial role in maintaining the stability of the banking system of the host country;
- Entry of Foreign Banks might introduce competitive pressure on the domestic banking system leading to reduction of deposit and credit rates;
- Cross-border lending which is the most popular instrument for attracting credits in Uzbekistan, Kyrgyzstan and Tajikistan is less stable than local credit that might be provided by the same foreign bank in the domestic economy;
- Foreign banks has a substantial effect on the movement of FDIs;

# Negative effects of foreign bank entry into transition economies of CARs

- The enhanced competition from entrance of foreign banks into domestic banking system might be threatening to the market position of weak domestic banks;
- Foreign subsidiaries are controlled centrally as a consequence these banks might cut their operations in the host country during the economic downturn in the economy, which might be harmful to the stability of the banking system;
- Fear of foreign control is another argument against the entrance of foreign banks into domestic economy;
- Foreign banks might be overly interested in promoting export from their home country or in supporting projects undertaken by home country firms

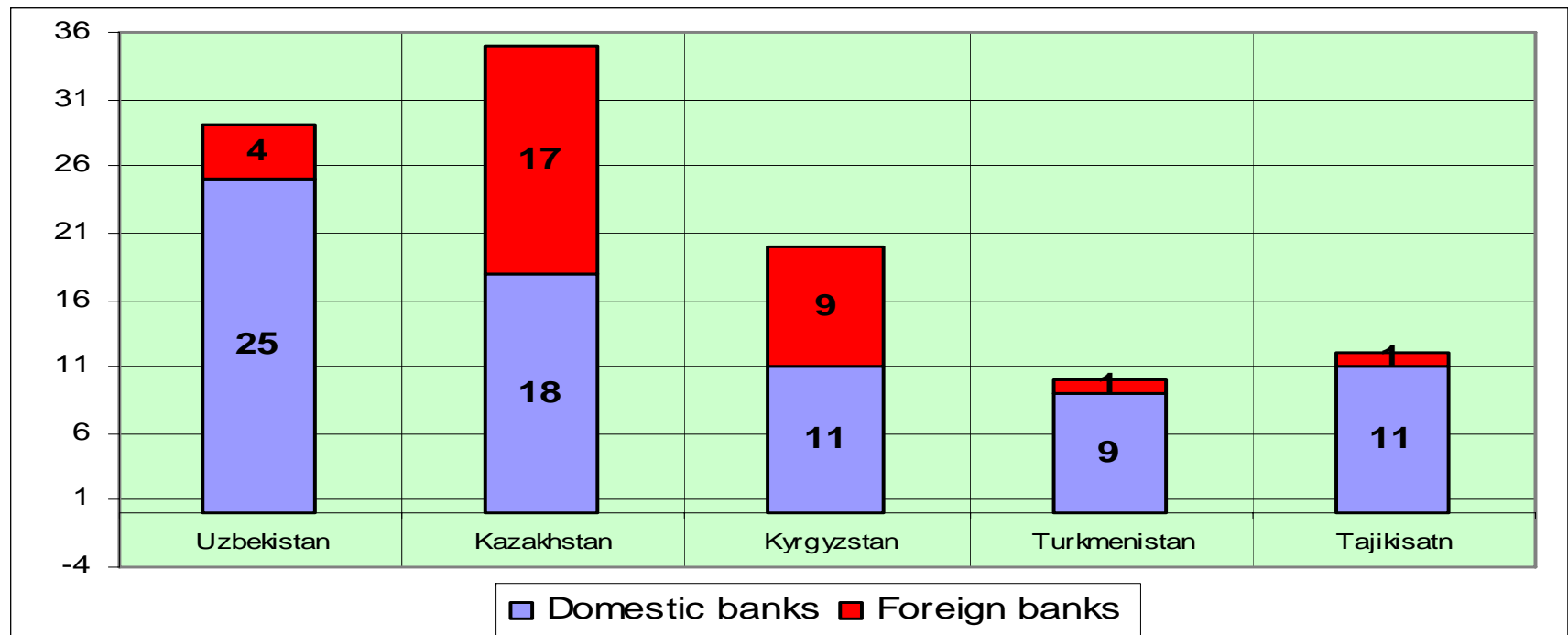
# Presence and capitalization of foreign banks in CARs

- The most matured and developed banking systems are persistent to Kazakhstan, Uzbekistan and Kyrgyzstan.
- As for 2005, the biggest number of banks was in Kazakhstan - 35 banks; the second country is Uzbekistan with 29 banks and in Kyrgyzstan the total number of banks is equal to 20.



# Presence and capitalization of foreign banks in CARs

- Kazakhstan and Kyrgyzstan are the most open economies for entrance of foreign banks, which is not the case for the rest representatives of Central Asian region. Among 35 banks in Kazakhstan 17 are foreign banks, while in Kyrgyzstan 9 banks out of 20 belong to foreign banks;
- Uzbekistan's banking sector is home for only four foreign banks. Turkmenistan and Tajikistan remain the closest economies for entrance of foreign banks, as at present there is only one foreign bank functioning in each country.





## Presence and capitalization of foreign banks in CARs

- The capitalization of the banking sector of all five Central Asian countries is estimated at 34803 bln. USD in 2005, demonstrating a growth equal to 74.6% in contrast with the capitalization in 2003, which once again assures of persistent huge potential of this region for further growth in upcoming years;
- The continues development of financial intermediation market and growing demand for banking services in the countries of Central Asian region are the key factors that will boost the growth of the banking sector capitalization in the short to mid term;
- The Central Asian banking sector is heavily underestimated;
- However, the potential for further growth is comparatively different among Central Asian Republics
- In 2005 the booming growth of the largest Kazakh banking sector capitalization in Central Asian region has constituted 120.1% in contrast with 2003, while Uzbekistan with the second largest banking sector capitalization in Central Asian region had a growth of only 8.8%;



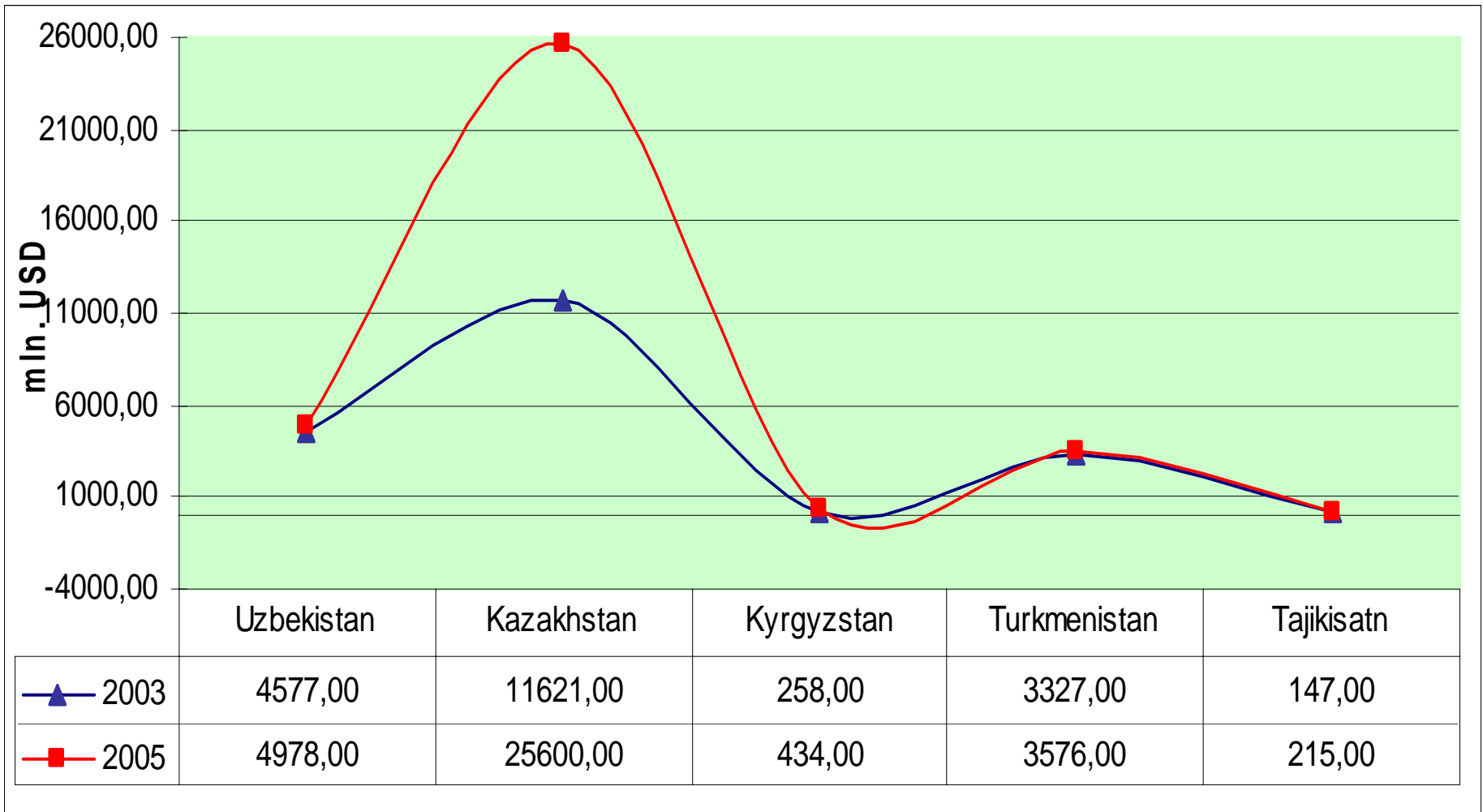
# Instance of Kazakhstan as a paradigm for CARs

- Monetary authorities of Kazakhstan were among the first in Central Asian region to adopt policies that were targeted at refining macroeconomic conditions, which has resulted in significant achievements of Kazakh government:
  - in recent years annual real growth of GDP was equal to 8-10%;
  - significant reduction of inflation rate to level 6-8%;
  - elimination of fiscal balance deficits;
  - improving investment climate that has secured the entrance of approximately 27.3 bln USD of foreign direct investment (FDI) within the period of 1991-2005 which is the highest FDI flow in the region of Central Asia;
  - privatization of state-owned bank - as for 2005 among the five biggest banks in Kazakhstan four were foreign banks;
  - liberalization of credit and deposit rates which has boosted the inter-bank lending market;
  - judicial reform which has made possible adoption of international rules and regulations governing financial institutions and adoption of international accounting standards.

# Presence of foreign banks in CARs

- The enhanced creditability of Kazakh banking sector has justified extended presence of foreign banks in this particular country;
- In 2005 the capitalization of foreign banks in the overall Kazakh banking sector made up 81% with the total capitalization of foreign banks equaling to 20736 bln. USD, the same scenery is observed in Kyrgyzstan where the capitalization of foreign banks in the overall banking sector is equal to 76%;
- In 2005, the share of foreign bank's capitalization in the Tajik banking sector constituted 9.7%, while the share of capitalization of foreign banks in the overall banking systems of Uzbekistan and Turkmenistan constitute 0.37% and 0.12% respectively.

# Capitalization of CARs' banking sector



# Share of foreign banks in the capitalization of CARs' banking sector as of 2005

|   | Uzbekistan | Kazakhstan | Kyrgyzstan | Turkmenistan | Tajikisatn |
|---|------------|------------|------------|--------------|------------|
| Total capitalization of banking sector (mln. USD) | 4978,00    | 25600,00   | 434,00     | 3576,00      | 215,00     |
| Capitalization of foreign banks (mln. USD)        | 18,42      | 20736,00   | 329,84     | 4,29         | 20,86      |
| % of foreign ownership                            | 0,37       | 81,00      | 76,00      | 0,12         | 9,70       |

# Market concentration in the banking sector of CARs

- Market concentration in the banking sector of CARs differs between countries where there is comparatively less concentrated banking sector as it is in Kyrgyzstan and Tajikistan and countries with high concentration of banking system as Turkmenistan and Uzbekistan and to the lesser extent in Kazakhstan;
- High concentration of state owned banks in the financial services market secures opportunity for leading state owned banks in Uzbekistan and Turkmenistan to uphold their own commercial interests and determine the prices for the provided services at the levels that are favorable for them in terms of profitability;
- The above-mentioned factor destabilizes the competition in the market and finally might lead to underestimation of credit risk of the banking sector and to inability of banks to increase credit rates that would justify risk taken by banks by channeling credits to the more risky projects, thus Uzbek and Turkmen banking sectors are characterized with less liberalized deposit and credit rates.

# Comparative analysis of domestic and foreign banks' performance in CARs as for 2004

|                                      | Equity / Assets | Net Interest Margin | Return on Equity (ROE) | Return on Assets (ROA) | Cost to Revenue Ratio |
|--------------------------------------|-----------------|---------------------|------------------------|------------------------|-----------------------|
| <b>Uzbekistan</b>                    |                 |                     |                        |                        |                       |
| Average indicator for domestic banks | 20,47           | 8,88                | 21,29                  | 4,62                   | 54,79                 |
| Average indicator for foreign banks  | 25,67           | 4,91                | 19,00                  | 4,58                   | 45,46                 |
| <b>Median</b>                        | <b>23,07</b>    | <b>6,90</b>         | <b>20,15</b>           | <b>4,60</b>            | <b>50,13</b>          |
| <b>Kazakhstan</b>                    |                 |                     |                        |                        |                       |
| Average indicator for domestic banks | 14,56           | 5,70                | 21,44                  | 3,39                   | 58,55                 |
| Average indicator for foreign banks  | 9,12            | 7,74                | 15,14                  | 1,42                   | 44,70                 |
| <b>Median</b>                        | <b>11,84</b>    | <b>6,72</b>         | <b>18,29</b>           | <b>2,41</b>            | <b>51,62</b>          |
| <b>Turkmenistan</b>                  |                 |                     |                        |                        |                       |
| Average indicator for domestic banks | 4,28            | -                   | 7,99                   | 0,34                   | 67,41                 |
| Average indicator for foreign banks  | 48,70           | -                   | 1,53                   | 0,74                   | 91,19                 |
| <b>Median</b>                        | <b>26,49</b>    | <b>-</b>            | <b>4,76</b>            | <b>0,54</b>            | <b>79,30</b>          |
| <b>Kyrgyzstan</b>                    |                 |                     |                        |                        |                       |
| Average indicator for domestic banks | 15,52           | -                   | 21,68                  | 4,75                   | 70,83                 |
| Average indicator for foreign banks  | 24,49           | -                   | 12,91                  | 2,27                   | 80,09                 |
| <b>Median</b>                        | <b>20,01</b>    | <b>-</b>            | <b>17,29</b>           | <b>3,51</b>            | <b>75,46</b>          |

# Comparative analysis of domestic and foreign banks' performance in CARs as for 2004

- In Uzbekistan, Kazakhstan and Kyrgyzstan assets were used better by the management of domestic banks (with ROA ratio equal to 4.62, 3.39 and 4.75 respectively) rather than management of foreign banks (with ROA ratio equal to 4.58, 1.42 and 2.27 respectively), while the vice versa was true for Turkmenistan;
- In average, management of all domestic banks in CARs increased shareholders' wealth much higher than the management of foreign banks did;
- In average foreign banks were less indebted in contrast with domestic banks in Uzbekistan, Turkmenistan and Kyrgyzstan, while in Kazakhstan the vice versa was true;
- Uzbek banking sector has outperformed the banking sector of Kazakhstan, Turkmenistan and Kyrgyzstan. Uzbekistan banking sector has scored the highest median indicator for ROE and ROA and the lowest cost to revenue ratio equaling to 20.15%, 4.60% and 50.13% respectively;
- banking sector in Turkmenistan was the most inefficient in 2004, as Turkmenistan's banking sector scored the lowest ROE and ROA and the highest cost to revenue in the Central Asian region.

# Conclusion



- Nevertheless, foreign banks have higher information processing capability, better product sophistication and are more creditable in contrast with domestic banks in eyes of depositors which secure foreign banks from "unreasonable risk" in their operations; still above-mentioned factors do not provide competitive advantage for foreign banks to be more profitable and efficient in countries of Central Asian region;
- The analysis for 103 banks in Central Asian region out of which 29 were foreign banks demonstrated that in 2004 domestic banks in Uzbekistan, Kazakhstan, Turkmenistan and Kyrgyzstan have outperformed foreign banks in such ratios as ROA and ROE, which means that management of domestic banks have created more shareholders wealth and used assets more efficiently, than the managers of foreign banks did;

# Conclusion



- Interdiction of foreign branching does not seem to be a barrier for entrance of foreign banks into Central Asian republics. Moreover, Kazakhstan and Kyrgyzstan dispose with the most open banking sector for offshore banking activities;
- Huge potential of this region for further growth in upcoming years due to further development of financial intermediation market and growing demand for banking services;
- The banking sectors of Uzbekistan and Turkmenistan are the most underestimated among the CARs.