



## THE ROLE OF MULTINATIONAL BANKS IN EMERGING MARKET ECONOMIES

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### ABSTRACT:

Banks have always engaged in international business. They have dealt in foreign exchange, extended credit in connection with foreign trade, traded and held foreign assets, and provided travellers with letters of credit. All this and some other types of business the banks historically have carried out from their domestic locations. There was no need for a physical presence abroad. Business that could not be carried out by mail or telecommunications was handled by correspondent banks abroad.

Some banks began to establish a physical presence abroad in the late 19th and early 20th century. This move abroad mostly was part of colonialism. Under the umbrella of the home country's colonial government, banks from Britain opened branches in the Indian subcontinent, Africa, Hong Kong, and Singapore; European and North American banks moved into the Caribbean and Latin America. These banks provided modern banking services to economies which previously had no or only a relatively rudimentary financial industry.

### INTRODUCTION

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Multinational, also sometimes called transnational, banking is of relatively recent origin. Its development coincided and accelerated with the technological improvements and cost-reductions in international travel and communications in the post-war period. This type of banking involves the physical presence of a bank abroad.

The most prevalent and versatile legal form of this presence is a branch, which uses the home-country bank's name and organization. It is usually an independent corporate entity with limited liabilities, whose shares are owned by the parent. Other legal forms used in

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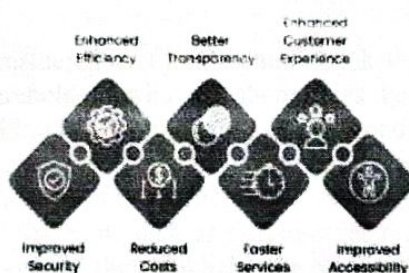
foreign physical presence are agencies and representative offices, which have limited legal operational authority but also limited liabilities. Subsidiaries are used if ownership is shared with other firms or individuals, mostly residents of the country hosting the foreign bank. These subsidiaries are mostly corporations with limited liability. In addition, of course, banks have maintained networks of correspondent banks for doing business in locations where they have no physical presence.

### MEANING OF MNB

Multinational banking involves the ownership of banking facilities in one country by the citizens of another'. The definition of a MNB is subject to an array of interpretations and is also used interchangeably with terms such as International Bank or Transnational Bank. Broadly, a multinational bank can be classified as an institution through correspondent relationship, foreign direct investment or direct lending to customers from home offices that engages into cross country banking. In many instances, however, multinational bank is used to refer to a bank with physical presence outside its home country through a branch, an agency, a wholly or a majority owned subsidiary, or a bank formed by merger of two or more banks based in different countries and not the ones with a correspondent relationship or a representative office. Robinson (1972) defined Multinational banking as 'operating a bank in, and conducting banking operations that derive from, many different countries and national systems'.

A multinational bank can be compared to a multinational company and can be classified as a financial multinational corporation as they enjoy similar advantages and disadvantages in host country. However, this theory can only be applied to commercial bank that engages in local banking activities in the host country and hence competes with the native banks. Whereas, a Multinational corporation can little be compared with the bank that operates in the super national markets such as Euromarkets as they do not compete with the local indigenous banks.

### Key Elements of FinTech Transforming the Banking Industry



### ORGANIZATIONAL STRUCTURES IN MULTINATIONAL AND INTERNATIONAL BANKING

When establishing a physical presence in an offshore market, a bank can choose from a range of possible organizational structures. Each of these structures offers different combinations of advantages and disadvantages, some of which will depend on the particular host nation regulations. In some nations certain organizational structures may be prohibited.



### **(1) Correspondent Banking**

Correspondent banks act to clear transactions between banks. These relationships enable banks to meet the requirements of domestic customers' foreign exchange and trade dealings. The domestic bank appoints a foreign bank to act as its agent for transactions in that foreign country. Correspondent banking has the advantage of being a relatively low cost method of accessing a market, particularly a market where establishment costs are large or regulatory barriers to entry are high. By engaging in international correspondent banking, the domestic bank has low cost access to the expertise of the foreign bank's corporate and international departments, without the cost of establishing a physical presence offshore

### **(2) Representative Offices**

A representative office is a small office in the host nation that coordinates a bank's correspondent banking relationships and renders assistance to the bank's existing customers. The office often has a secondary role of disseminating information about the parent bank and collecting information about the host country. Representative offices cannot raise liabilities or create assets; instead, they seek out information about the host environment to determine if profitable business opportunities. Representative offices are often used to coordinate matters relating to correspondent relationships such as check clearance, trade transactions, and foreign exchange matters. Representative offices can be run on relatively low budgets and as a result can be easily opened and closed.

### **(3) Agencies**

Agencies provide advantages over representative offices in that they can conduct transactions. The activities permitted to agencies vary according to host country laws, with some nations prohibiting agency activity by multinational banks. The usual limitation on an agency is that it cannot raise or solicit deposits. Exceptions do exist in that some countries allow agencies to accept credit balances from residents that are linked to a specified purpose. Such credit balances usually have other limitations as to length of time and terms of access.

### **(4) Consortium Banks**

A consortium bank can be considered as a joint venture bank separately incorporated and owned by two or more shareholders who are themselves banks, usually of different nationalities. Consortium banking is often the only possible method for small and medium sized banks to access the Euromarkets. The consortium bank enables capital and expertise to be pooled to the mutual advantage of the participants. Some consortium banks are formed to service a particular market segment, such as cross-border mergers and acquisitions or project finance. Another reason for the establishment of a consortium bank may be to access a particular geographic market. Some nations have banking regulations that require host country participation and as a result a consortium structure may be appropriate.

### **(5) Merchant Bank Subsidiaries**

A merchant bank subsidiary is a merchant (investment) bank that is wholly owned by a bank located in another country. It offers a method of entering a host country without the constraints that may be imposed on a full banking entry. Such a subsidiary would offer the full range of wholesale services but would be disadvantaged by lower credit ratings than



would be the case with a full banking license. This lower credit is due to the perception that merchant bank subsidiaries are not subject to the same level of prudential supervision.

#### **(6) Edge Act Corporations**

Edge Act Corporations are an organizational structure unique to the United States. The Edge Act (an amendment of Section 25 of the US Federal Reserve Act) allows US banks and foreign banks to conduct international banking and finance activities in states outside their state of incorporation in the United States. Edge Act corporations can conduct a wide range of banking activities including accepting liabilities other than savings deposits, financing international trade, and making loans. These activities must be related to international transactions.

#### **(7) Bank Branches**

A foreign bank branch is a branch located in a different country from the country of incorporation of the parent bank, without the branch itself having separate incorporation. As such, the branch is integral to the parent and is not separately capitalized. The branch will carry on banking business, subject to the laws of the host nation. The restrictions imposed on foreign branches are such that they usually have the ability to offer a nearly comprehensive range of banking services, with restrictions on access to the retail market being usual. As the branch is not legally separate from the parent, it has access to the full support, credit rating, and capital base of the parent.

#### **(8) Bank Subsidiaries**

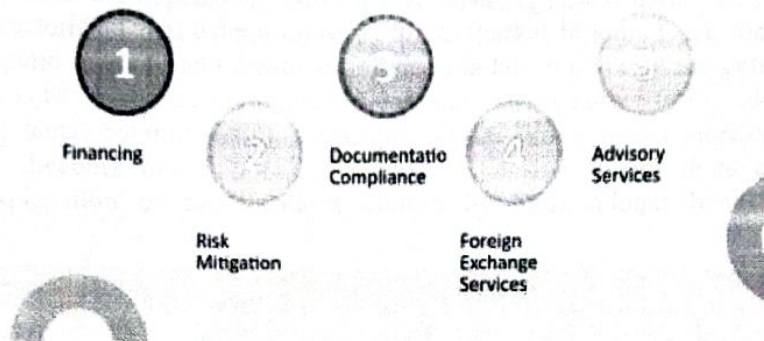
A bank subsidiary is a separately incorporated bank that is controlled by a parent located in another country. Such subsidiaries are generally wholly owned, as this reduces potential problems associated with dissenting minority shareholders. The host nation regulations imposed on foreign bank subsidiaries often determine whether this organizational structure is chosen. Generally, as discussed above, multinational banks prefer the bank branch structure to the bank subsidiary structure. However, in some cases, the host nation regulator will not permit foreign bank branches to be established, mainly due to concerns regarding prudential regulation

### **REASONS FOR EXPANSION OFF SHORE BY MULTINATIONAL BANKS**

A number of reasons have been advanced to explain why banks expand offshore. The most frequently discussed idea is that banks expand offshore in order to follow their clients. This is usually characterized as defensive expansion. This approach argues that banks must follow their clients abroad in order to retain (defend) their bank--client relationship. If the bank does not follow its clients abroad, the client will establish a new banking relationship in the host nation. This new banking relationship could expand to supplant the bank--client relationship in the host nation. The defensive expansion relationship could reflect either foreign direct investment (FDI) or trade relationships, or both.



### The Role of Banks in Facilitating Usance Transactions



As discussed in the previous section, host nation regulations will in most cases determine the organizational structure adopted by a multinational bank in the host nation. Likewise, regulation can act to encourage international and multinational banking in general, and act to determine the location choice when expanding offshore.

Domestic regulation has acted to encourage offshore banking as a means of escaping the impact of restrictive home nation regulation. Likewise, less restrictive host nation regulations will attract foreign banks to that location.

In line with the Hymer-Kindleberger Theory, it is argued that entrants to a foreign market must possess some special advantage if they are to overcome domestic banks' home-territory advantage. It has been argued that the Hymer-Kindleberger approach is best applied to multinational banking within the framework provided by internalization theory.

Consistent with this general framework, banks from developed financial markets have skills and expertise that can be applied to overseas markets at relatively low marginal costs. Owing to market failure, these banks are unable to sell these skills, and so must expand offshore in order to reap the maximum returns from this advantage. Other examples of firm specific advantages that provide an impetus for offshore expansion include comparative advantage in the production of bank products, parent size, and international experience.

Comparative advantages in multinational banking are considered in terms of lower cost of capital, lower interest costs, and lower non-interest costs. Banks with lower costs of capital have the ability to provide bank products (deposits and loans) at a lower cost than their competitors. Due to difficulties in accurately calculating the cost of capital for multinational banks from publicly available data, the focus of comparative approaches to multinational banking has been on costs and non-interest costs. In general, the comparative advantage approach to multinational banking is consistent with the traditional Heckscher-Ohlin trade theory.

The parent size and capital base approaches to multinational banking are based on the observation that size and multi-nationality are frequently related. The causal relationship between size and multi-nationality is not clear, although the size of a bank's capital base is considered to be one of the determinants of international competitive success. A problem is that parent size and capital base have been found to be highly correlated with other measures of multi-nationality and of international experience.



As a result, it is not clear which aspect of the multinational bank parent size represents. Within the framework provided by internalization theory, the firm-client relationship (defensive expansion), comparative advantages, and parent size (capital base) are firm characteristics that cannot be sold, due to market failure. Thus, the multinational bank will expand offshore and create an internal market in place of the external one. The effect of this is to internalize the impact of external market failure to the advantage of the multinational bank, by minimizing transaction costs. While firm characteristics explain which banks become multinational, defensive expansion theory does not provide a complete explanation of the locations chosen by multinational banks for offshore expansion.



The internalization approach to multinational banking retains the assumption of profit maximization; thus the multinational bank will seek to expand to those locations that offer the greatest profit opportunities. A disincentive for offshore expansion is the level of competition in the host market. The more active the incumbent banks, the less opportunities multinational banks have to establish their operations. The degree of activity or incumbency of the host nation can be measured by the level of market concentration or by the level of domestic deposits. In general, the greater the level of incumbency, the fewer the opportunities for multinational banks to establish a successful *ab initio* presence.

### CONCLUSION

The role of multinational banks in emerging market economies (EMEs) has been pivotal in driving economic growth, financial inclusion, and integration with the global financial system. These banks, with their international presence and financial expertise, significantly influence the banking landscape and the broader economy of the countries they operate in. Through their operations, multinational banks contribute to the development of financial infrastructure, improve access to capital, and facilitate international trade and investment. Their role has grown exponentially in recent decades, largely due to the liberalization of financial markets, globalization, and advancements in technology. As a result, multinational



banks are now indispensable actors in the economic development of emerging markets, providing both opportunities and challenges.

First, multinational banks bring with them significant capital inflows into emerging economies. These banks often operate with large financial resources, and their entry into EMEs typically involves substantial investments that can boost the availability of credit. By offering loans to domestic companies, particularly to small and medium-sized enterprises (SMEs), multinational banks facilitate growth by expanding the pool of financing available for innovation and expansion. This is particularly crucial in emerging markets where access to capital has traditionally been limited due to a lack of domestic financial resources or the high cost of borrowing from local banks. Multinational banks also play a key role in reducing the cost of borrowing by introducing more competitive interest rates and offering diverse financial products. This, in turn, encourages economic activity and fosters entrepreneurship, which is essential for long-term growth in emerging economies.

Moreover, multinational banks play a critical role in enhancing financial inclusion in emerging markets. In many developing countries, access to banking services is limited, especially in rural or underbanked areas. Multinational banks, with their advanced technological infrastructure, can reach these underserved populations, offering financial products such as savings accounts, mobile banking services, and microloans. By leveraging mobile banking technology, for example, multinational banks have been able to bring banking services to remote areas, allowing individuals and businesses to participate in the formal financial system. This contributes to reducing poverty, fostering financial literacy, and enabling economic mobility in emerging markets. Additionally, multinational banks have introduced a wide range of financial products tailored to local needs, such as consumer loans, mortgages, and insurance, further supporting financial inclusion.

Furthermore, multinational banks contribute to the financial deepening of emerging markets. Financial deepening refers to the growth of financial institutions and markets, which in turn enhances the overall development of an economy. Through the provision of various financial instruments, such as bonds, derivatives, and foreign exchange products, multinational banks help to develop capital markets in emerging economies. This allows local businesses and governments to raise capital more efficiently, facilitating infrastructure development, industrialization, and economic modernization. By fostering the development of a diversified financial sector, multinational banks also encourage greater transparency and market efficiency, thus improving the overall functioning of the financial system.

Multinational banks also act as key intermediaries in facilitating international trade and investment. In emerging markets, these banks serve as crucial players in linking local economies with global financial markets. They provide trade finance, foreign exchange services, and payment systems, helping businesses in EMEs connect with international markets. By facilitating the movement of goods, services, and capital across borders, multinational banks enable emerging market businesses to expand their reach and access new customers. In addition, multinational banks often serve as advisors for foreign direct investment (FDI), helping multinational corporations establish operations in emerging markets and navigate local regulatory environments. The expertise of these banks in handling cross-border transactions and their familiarity with international regulations is invaluable for fostering global economic integration.



However, the impact of multinational banks in emerging markets is not without its challenges. One of the primary concerns is the potential for these banks to exacerbate economic inequality. While multinational banks provide essential services to businesses and individuals in emerging markets, their focus on profit maximization can sometimes result in the neglect of lower-income groups or smaller businesses that are less profitable. Additionally, multinational banks may prioritize their global operations and interests over those of the local economy, leading to a situation where financial resources flow out of the country rather than being reinvested locally. The presence of multinational banks in emerging markets can also lead to increased competition for local banks, which may struggle to compete with their more resource-rich counterparts. This could ultimately lead to the consolidation of the banking sector, with smaller local banks being absorbed by larger multinational institutions, reducing the diversity of the financial system.

Another significant challenge is the vulnerability of emerging market economies to global financial shocks. Multinational banks are deeply integrated into the global financial system, and as a result, their operations can be influenced by developments in other parts of the world. For example, financial crises or economic downturns in advanced economies can lead to a tightening of credit conditions and a reduction in investment in emerging markets. During times of global financial instability, multinational banks may also repatriate capital to their home countries, leading to capital outflows from EMEs and exacerbating economic downturns. The volatility in global financial markets can therefore undermine the stability of emerging markets, particularly those that are heavily dependent on foreign capital inflows.

Moreover, the regulatory environment poses another challenge for multinational banks operating in emerging markets. Although multinational banks bring expertise and capital to these economies, they must navigate complex and often unstable regulatory frameworks. In many emerging markets, regulatory systems may be underdeveloped, inconsistent, or prone to changes due to political instability or shifting policy priorities. Multinational banks are often required to comply with both local regulations and international standards, which can be a challenging task. In some cases, regulatory loopholes or lax enforcement can lead to unethical banking practices, such as money laundering or tax evasion, undermining the stability of the financial system. Multinational banks must be proactive in ensuring that they adhere to ethical standards and comply with local regulations, while also contributing to the strengthening of regulatory frameworks in emerging markets.

In conclusion, multinational banks play a crucial role in the economic development of emerging market economies by providing capital, facilitating financial inclusion, fostering financial deepening, and supporting international trade and investment. However, their presence in these markets is not without challenges, including concerns about economic inequality, the vulnerability of EMEs to global financial shocks, and the complexities of navigating local regulatory environments. To maximize the benefits of multinational banks while mitigating their potential risks, it is important for emerging market economies to adopt policies that promote financial stability, improve the regulatory environment, and ensure that the operations of multinational banks contribute to the long-term development goals of the country. This can be achieved through a collaborative approach between governments, multinational banks, and local financial institutions, aimed at creating an inclusive and resilient financial system that supports sustainable growth and development.



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