The globalization of commercial banking

James B. Bexley
Sam Houston State University

Paul Bond
Sam Houston State University

Bala Maniam
Sam Houston State University

Abstract

The world banking system has gone through many transformations in the last several decades. There have been dramatic regulatory changes, considerable advances in information and banking technologies, the widespread dominance and acceptance of the market economy by less open economies, and the increase and integration of international financial markets and institutions, have created new opportunities and challenges for international banking institutions. While these transformations have provided an expanded opportunity set for banks, they have intensified the completive pressure in the global banking arena as well.

Keywords: Globalization, Commercial Banking, Banking Technology, International, Markets

Introduction

Increasingly what happens in local neighborhoods is influenced by the activities of people and systems operating around the world. Banking and retailing, for example, have adopted new technologies that involve less face-to-face interaction. For example, your contact with the bank may be with a call center many miles away or when you buy goods on the internet the only person you might speak to is the delivery driver. Also, movements in the world commodity and money markets can have a very significant impact upon people's lives across the globe. Sophisticated information systems have made globalization possible. However, to show just how much the economy is impacted by globalization, all one has to do is examine the impact on all of the world markets when the U. S. economy had a downturn and when the European sovereign debt crisis occurred in Greece, Ireland, Italy, Portugal, and Spain.

The internationalization of financial markets, technology and some manufacturing and services bring with them limitations. In addition, the emergence of institutions such as the World Bank, the European Union and the European Central Bank involve new constraints. While the influence of nation states may have shrunk as a part of the process of globalization, it has not disappeared. A crucial aspect of globalization is the nature and power of multinational corporations. Such companies now account for over 33 percent of world output and 66 percent of world trade (Gray 1999: 62). Significantly, something like a quarter of world trade occurs within multinational corporations.

Economic Effects of Globalization on the Banking System

Banking has gone through many dramatic changes in the last two decades. International trade has had a major impact on the need to operate the banking system on a global basis. There have been extensive regulatory changes, advances in information and banking technologies, the acceptance of the market economy by former non-capitalist economies, and the increase in integration of international financial markets and institutions. These have created new opportunities and challenges for both the U.S. and international banking industries. While these have provided an expanded opportunity for banks, they have increased the completive pressure in the global banking arena. International banks continue to proliferate in countries other than their own which has a major impact on competition. The continued existence of a bank in this increasingly global competitive environment is directly linked to its performance and efficient operation.

Deregulatory banking acts, combined with increased globalization and the integration of financial institutions and markets, create a more competitive environment that should increase the efficiency of banking operations in general. It is perceived that increased competition due to globalization and deregulation should affect small banks and large banks similarly. “The banking sector is one of the most important economic sectors and the most influential and responsive to changes, whether international or domestic (Kenawy pg.55)".

The larger banking entities, by virtue of their economic power, economic size and high economic performance, have a high capability to influence the market trends and global growth of banks in all parts of the world. Banking globalization does not mean abandoning the national domestic market, but moving to provide banking services inside and outside, maintaining the national position and becoming more effective, capable and active to ensuring banking expansion. Globalization is not a framework for action in so much as it is a motivator of expansion. Thus, banking globalization draws on several reasons and, at the same time, must be linked to the growth of the bank and its expansion while enhancing its' capabilities.

Many studies of globalization indicate that it has a large-scale impact on the banking system of any country in the world. The economic effects of globalization on the banking system may be positive or negative, and the task of those in charge of the management of the banking system is to maximize the positive effects and minimize the negative ones. Reference may be made to a number of serious economic effects of globalization on the banking system conducting the following analysis.

First there needs to be a diversification of banking activity and the tendency towards dealing in financial derivatives. This includes the diversification of banking services at the funding sources, the issuance of marketable deposit certificates and long-term loans from outside the banking system, the diversification of loans granted and the establishment of banking and securing holding companies. In other words, bank debts need to be transferred to securities and engaging in new investment areas such as investment banking and the financing of the privatization at the income level to engage in non-banking areas, then the tendency to deal mainly in currency transactions, issuing of securities, the establishment of investment funds, and insurance issuance through sister insurance companies for the management of investments of holding companies for the benefit of customers.

With increasing globalization, banks became exposed to risks both external and internal and had to be cautious about risks using several means. The most significant of these is strengthening capital. The criterion of capital adequacy became increasingly important since it was approved by the Basel Committee in 1988, and it became necessary for banks to abide by it as a global criterion. Banks were affected but this criterion as the ratio of their capital to total at-risk assets after weighting them against credit risks must reach at least 8% by the end of 1999. While Basel reform continues go through different stages, it is a reality that it will bring about a formal capital requirement for banks of all nations. Globalization refers to the unification and integration of global markets for both capital and money markets. This must be through the swaps mechanism and arbitraging accompanying for differences in international prices. This has allowed the possibility of banks and other financial institutions management to carry out their activities in the various financial markets throughout the world simultaneously. Global changes forced banks and other institutions to compete with one another. At the same time, large banks appeared to expand the scope of the market, reduce cost and maximize profit through service, speed, innovation and meet the needs of the consumer. In order to achieve these objectives, knowledge is an important factor of production. In order to be competitive banks and institutions require conversion strategies to expand geographically and to open new markets and the challenge of competitors.

Through a review of the most important global and local changes and their impact on banks, we can say that the most important challenges facing banks today are the risks related to the change in product mix with increased competition, and obtaining the resources needed, especially human resources, for the new roles and requirements of the application of banking legislation. The identification of the banking strategy in which the bank should seek for sectors in which there is a comparative advantage, and which advantages may develop that may become relative later on must be identified by the bank. The bank must expand the product mix and banking services continuously so that they may become integrated and convenient to customers, rather than relying on traditional financial services to achieve profit margins and have effective control their costs. There needs to be a restructuring of community banks. Taking into account the rapid development of technology, so management can approach the levels of marketing, and focus on the promotion of banking services is the challenge for the future. Banks also need to manage risks in lending operations to meet the rapid changes in positions of debtors with emphasis on the importance of policies for the management of assets and liabilities. Community banks also need to work to develop human resources through rehabilitation and training in such a way as to fit with the developmental process and the requirements of modern banking technology. There needs to be implementation of modern banking technology and introducing modern services and products to deliver those services to clients in the local market.

The impact of globalization and information technology on the banking industry

Increased globalization and the integration of financial markets result in more efficient dissemination of information and advances in banking technology, you would expect to find increased growth in commercial banks. Furthermore, you would expect large banks to progress technologically more than their smaller counterparts, since they are in a better position to take advantage of international exchanges of new technologies and emerging innovations. Large banks are found to be significantly more efficient than small banks.

Information technology (IT) creates new opportunities for banks in the way they organize product development, delivery and marketing. IT also allows other financial and even non-financial organizations to start offering bank services. Deregulation both within countries and across national boundaries allow increased international competition between banks, financial and non-financial organizations. Banking markets are also becoming more international. The combination of new IT, deregulation and globalization ensure that the traditional barriers to entry in the banking industry are broken down. This can be easily seen in the internationalization of retail financial services (including banking) particularly across Europe and the US. Increases in the competitive forces in banking have led to a decline of traditional banking indicated by a reduction in the profitability of banks. The most striking evidence of this is the reduction in income from lending activities as a percentage of total income. This decline in traditional banking has led some to question the long-term viability of retail banks. The decrease in the profitability of traditional banking is attributed to a number of factors including increased competition, poorly performing loans and high cost bases.

A high cost base can be reduced over time. However the level of competition is unlikely to diminish. Globalization and information technology are creating a more unstable banking environment in which new entrants and bank services are reducing the traditional income streams of banks. The increasing unification of financial markets and the ability to link directly to the market has created opportunities for institutions to automatically pass specific elements of risk to the capital and money markets at a minimal cost. The banks with the ability to provide automated links to their customers can serve a global customer base of financial institution in a timely fashion without facing capacity restraints. The institutions that are willing to link together risk takers can free up capital to invest in areas where they believe they have strength.

The ability to directly access customers electronically reduces the barriers into new markets and link electronically to existing institutions serving a market provides the opportunity of selling branded financial products through established distribution channels. The community banks serving a large portion of a local market need to determine which parts of the value chain have the potential to be developed into globally competitive businesses. By working in partnership with other institutions to reduce the elements that require investment and focusing on areas of strength, the community bank can continue to improve the capabilities and services provided to their current customer base and reduce the actual cost of the supporting of these services. “The banks that continue to operate a vertically integrated structure focused on cutting the costs of each specific process by merging with similar organizations or improved process control are in danger of being unable to respond to the improvement in the financial services offered by institutions focused on specific global market segments” (Holland). If the existing community bank fails to recognize a reduction in market share in a timely basis they are unlikely to be able to react in time to recoup their position.

Banking globalization and monetary transmission

The globalization of banking in the United States is influencing the monetary transmission mechanism both domestically and in foreign markets. The call reports for all US banks who filed between 1980 and 2006 show that globalized banks activate internal capital markets with their overseas affiliates to insulate themselves partially from changes in domestic liquidity conditions. The existence of these internal capital markets directly contributes to liquidity shocks caused by lending to affiliated banks abroad. While these results imply a more active lending channel, they imply that the lending channel within the United States is declining in strength as banking becomes more globalized and monetary transmission abroad increased in strength.

In the increasingly more globalized financial markets, the share of total U.S. banking assets is accounted for by banks with significant operations in foreign countries. It is not obvious how the process of banking globalization should affect monetary policy. An argument supporting this is that banks with international operations can respond to a domestic liquidity shock by reallocating funds between the head office and its’ foreign affiliates. This argument presumes that banking organizations actively operate their own internal capital markets, and that global banks can move liquid funds between domestic and foreign operations on the basis of their need. If this holds true, the domestic lending channel of monetary policy could become less effective, but the effects of monetary policy would not disappear.

If global banks respond to the liquidity shock through an internal reallocation of funds, their foreign lending capability may be affected. So banks going global may increase the international transmission of domestic monetary policy. Kashyap and Stein (2000) showed that U.S. banks in the top 5 percent of the asset distribution are virtually unaffected by U.S. monetary policy. The association between bank globalization and bank size is certainly important. Most global banks are in the top 5 percent of the asset distribution. So, by this argument, by the time a bank expands its’ operations to include foreign countries, monetary policy has already become unimportant for its’ lending. In this case, banking globalization is unlikely to have an impact on monetary policy effectiveness. Large global banks are insulated from monetary policy, while large banks with domestic-only operations are found to be sensitive to changes in U.S. monetary policy.

This can be interpreted as an indication that insulation from monetary policy derives from the global nature of banks, since otherwise large banks would not seem to be fully insulated by their access to external financial markets. Consequently, global banks may have a different type loan demand that is less dependent on domestic economic and liquidity conditions. In times of a contracting monetary policy, internal funds flow from foreign operations to the head office and vice versa with liquidity expansions. It is possible that these internal flows are just picking up internal reallocations that chase better rates of returns of the global asset portfolio and responding to changes in interest rates, both domestically and abroad, instead of for internal funding needs. If internal capital markets are at work, the lending activity of the foreign offices should be directly affected by domestic monetary policy. Overall, banking globalization seems to have an independent effect on monetary policy beyond any impact coming from the increase in bank size. Access to alternative sources of external financing is certainly important to monetary policy insulation. However, it has been shown that banks with global operations make significant use of internal borrowing and lending between their head offices and their foreign offices.

It has been found that small banks that are affiliated with large, global banks are indeed insulated, but small banks affiliated with large, non-global banks exhibited sensitivity to monetary policy changes. At the same time, the increase in globalization suggests that the lending channel within the United States is declining in strength. The main argument behind the lending channel of monetary policy is that tight money should reduce the volume of reserves held by depository institutions. The lending channel for monetary policy arises because a bank faces a significant edge in the cost of acquiring insured, reservable deposits and the cost of acquiring other sources of funds. A contractionary monetary policy drains reserves from the economy and reduces the amount of reservable deposits. This translates into a reduction in bank lending activity when banks are unable to replace each dollar of deposits with other funds. When using the Call Report Data of individual U.S. banks, Kashyap and Stein showed that loan sensitivity to monetary conditions was statistically more important for smaller banks in the United States, but not for the larger banks. Larger banks presumably have a greater ability to raise alternative sources of funds from external capital markets.

If global banks are insulated from domestic liquidity shifts just because of their size, there should not be any abnormal activity in the functioning of their internal capital markets between parent banks and their foreign affiliates around times of changes in monetary policy. When the internal capital market is in operation and used to partial offset of domestic monetary policy shocks, it should be expected to find an increase in the inflow of funds or a decline in outflows of funds from foreign operations in times of tight domestic monetary policy. This internal capital market response between the parent and foreign affiliates should be reflected in a positive sum of the coefficients on the monetary policy indicators. If monetary conditions in countries that have U.S. bank affiliates move in correspondence with U.S. monetary conditions, the incentive of the U.S. parent bank is to reallocate funds between parents and foreign affiliates might be reduced. The logic is that banks with weaker capital positions might rely more on internal capital markets in the event of a liquidity shock when compared with their well-capitalized counterparts.

When global banks operate an active internal capital market between their domestic and their foreign operations, the lending activity of the foreign affiliates should be affected by domestic liquidity shocks. If an active internal capital market is in operation, the lending activity of the foreign offices should depend on the liquidity of the domestic head office. Global banks tend to have less liquid assets, lower capitalization, and higher nonperforming loan shares. Portfolios of global banks tend to be similar in terms of loan to asset ratios, but commercial and industrial loans play a larger role in the business base. The portfolios of large banks are consistent with lessons from Berger (2005), where it is argued that the bank size is correlated with the bank business model. Larger banks tend to lend at a greater distance, interact with their customers at a greater distance and less exclusive and short lived relationships with their customers.

In recent years, the flows from affiliates to parents have substantially exceeded flows from parents to affiliates. While total foreign lending has been rising, domestic lending is rising faster, so foreign loans are declining as a share of total bank lending. The flows from foreign affiliates to parents show that affiliated foreign banks have assets that tend to be directed towards U.S. markets. Interestingly, large, but domestic-only banks seem less insulated. The size of the coefficients suggests that the Economic magnitude of the effect of monetary policy on lending of the large, non-global banks may not be very large as referred by the coefficients shown in Cetorelli (2008). This can be expected these referred to be Cetorelli (2008) are still institutions that, because of their size, are able to access external financial markets. This shows that large global banks, not including the largest, are insulated from monetary policy, while large, non-global banks display a degree to lending sensitivity. Only non-global banks in the top 1 percent can be found to be wholly insulated.

Global banks can operate an internal capital market that allows them to move resources between domestic and foreign operations depending on their liquidity needs. So bank might take advantage of a higher fed funds rate that may signify a higher return in the United States. The foreign operations of this bank may reallocate their resources accordingly. However, if this was the case, foreign offices would simply increase their position in their domestic assets on the balance sheet through purchases of government securities or any other means that is available to them. Foreign affiliates help insulate global banks against domestic liquidity shocks, this does not mean that the consequences of monetary policy are smaller than in the absence of globalization. While some insulation occurs in U.S. domestic markets, the transmission of U.S. monetary shocks can be magnified on foreign markets. Since foreign lending portfolios are typically much smaller than the total domestic loan portfolios, the impact of an outflow on the lending of foreign offices would be much larger than the impact of an inflow on domestic lending.

A banking system that grows increasingly more global may have enhanced resilience and self-adjustment in times of liquidity crisis. However, it may not rule out broader international shocks and the bank may have isolated intervention by national policy authorities. “The potential for viewing foreign markets as a liquidity buffer against U.S.-generated liquidity shocks may rely on the presumption that the cost of capital in foreign markets does not move in step with the U.S. federal funds rate” (Cetorelli pg. 24-25). It may be those branches and subsidiaries in countries where currencies are not pegged to the dollar are going to play the dominant liquidity buffer role. The implications of the globalization consequences for the lending channel could differ depending on whether their partners in banking contain countries that directly tie their monetary policies to those of the United States.

Financial Globalization

The financial globalization that has occurred since the mid-1980s can be seen by the surge in capital flows among industrial countries and between industrial and developing countries. Although these capital inflows have been associated with high growth rates in some developing countries, a number of these developing countries have also experienced periodic collapses in growth rates and significant financial crises that have had substantial macroeconomic and social costs. As a result, a debate has emerged on the effects of financial integration on developing economies. But much of this debate has been based only on limited empirical evidence. It is true that many of these developing economies, with a high degree of financial integration, have also experienced higher growth rates. Some general principles can emerge from the analysis about how these countries can increase the benefits from and control the risks of globalization. The quality of domestic institutions appears to play a role in this.

A large amount of evidence suggests that the quality of the domestic institution has an important impact on a country's ability to attract new foreign direct investment and their vulnerability to crises. Although there are different measures of institutional quality, there is evidence of the benefits of a robust legal and supervisory framework, low levels of corruption and good corporate governance. “There is an unresolved tension between having good institutions in place before capital market liberalization and the notion that such liberalization in itself can help a country import best practices and provide an impetus to improve domestic institutions” (International Monetary Fund 2003).

Financial globalization and financial integration are different concepts. Financial globalization is a concept that refers to the increased global linkages created through cross-border financial flows. Financial integration refers to a country's linkage to international capital markets. The volume of cross-border capital flows has risen substantially in the past decades. There has not only been a much greater volume of flows among industrial countries but also a surge of inflows from industrial to developing countries. Bank borrowing and financial portfolios are substantially more volatile than foreign direct investment.

Although accurate classification of capital flows is not easy, there is evidence that suggests the composition of capital flows can have an influence on a country's vulnerability to financial crises. The average per capita income for the more financially open and developing economies grow at a more favorable rate than that of less financially open economies. Financial globalization can help developing countries better manage output and consumption volatility. The volatility of consumption relative to output should decrease as the degree of financial integration increases. The essence of global financial diversification is that a country is able to shift some of its income risk to world markets. Although the volatility of output growth has declined in the 1990s, the volatility of consumption growth has increased for the emerging market economies in the 1990s which was the period of the rapid increase in financial globalization.

Financial globalization does not seem to be directly associated with the costs of the crises, but sudden stops from other countries in the region within the banking crises are linked to higher costs. The cost extends over time as investment declines during a banking crisis, which in return reduces long-term growth. Banks are well-suited as intermediaries to deal with the problems associated with the information in the financial sector. Since banks do not need to share information with each other, they have incentive to spend resources on obtaining information which they feel they can use in making loans or setting rates. Banks can also monitor the compliance with the conditions of a loan agreement. This allows firms to obtain finance at terms they deem to be reasonable. These bank activities are particularly important in emerging markets which do not have well-established financial markets or other sources of finance. In the absence of well-developed securities markets, companies rely on domestic banks for credit. Foreign capital may provide an alternative to the supply of funds, but investment has been shown to be tied to domestic savings.

Bank crises have severe consequences in emerging markets, since they interrupt the flow of savings to those sectors dependent on the banks. Companies which cannot obtain short-term credit or face high borrowing costs may fail and the economic activity in the area would decline. In some of the most serious cases, such as Mexico in 1994-95, East Asia in 1997-98 and

Argentina in 2001, the banking crises is accompanied by a currency crises which could cause the situation to worsen and result in two crises'. The resulting economic condition may take years to reverse and may never be fully made up. A rise in the domestic credit to the private sector is a sign of a lending "boom" which may precede a crisis.

Domestic savers have the ability to withdraw their funds from the bank. This gives them an incentive to monitor the activities of local banks and causes the banks to avoid risky lending which could cause the depositors to pull out. Moreover, both savers and lenders are able to diversity risk.

Emerging market countries which seek to avoid a crisis need to regulate their banks in order to prevent a "boom and bust" cycle. The closing of the country's capital account will not safeguard the country from the occurrence of a banking crisis, in fact the opposite holds true. A country needs to be careful as to which type of financial liability it uses. Debt is associated with an increased likelihood of a crisis.

Conclusion

To accomplish total globalization, a common currency must be established which will ease the entry of foreign banks into domestic markets that can contribute to more efficiency through increased competition. On the other hand, a currency crisis in an emerging market would exaggerate this situation. Domestic borrowers, including banks, that obtain funds from abroad, usually borrow in a foreign currency such as the dollar to give foreign investors some reassurance about the value of their investments. The effect of financial globalization, therefore, on domestic financial fragility is not simple. Foreign direct investment both lowers the incidence of banking crises and shortens its duration.

To face international competition, commercial banks must work to know all details about the market needs, but ensure that they do not conflict with the goals of their bank. They must also know the nature of their competition. Banks need to reinforce their financial resources through increasing capital and merging with small and weak banks to form more effective units in order to achieve the required reduction in costs. Banks need to develop human resources through rehabilitation and training in such a way as to fit with the developmental process and the requirements of modern banking technology. They need to implement the modern banking technology and introduce modern services and products to the customers in the local market. People and technological systems are becoming increasingly interdependent. It is something more than internationalization and universalization.

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