Chapter 6

Foreign Ownership and Bank Efficiency: Evidence from Turkey

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ABSTRACT

This chapter examines the association between Foreign Direct Investment (FDI) and efficiency of commercial banks in Turkey during the 2003-2010 period. First, the authors examine the technical efficiency of banks by applying the Data Envelopment Analysis (DEA) and financial ratio analysis following the relevant literature. Then, they attempt to shed light on the relationship between FDI and bank efficiency applying a second stage regression analysis. The results indicate that banks that have received FDI are more efficient than others whilst there is no significant correlation among the FDI dummy and bank efficiency in Turkey. Moreover, the analysis of balance sheet ratios suggests that foreign investors target more profitable and larger banks in the sector to form partnerships. Thus, consistent with Berger et al. (2003), the authors propose that efficiency is a pre-condition rather than a result of FDI in the Turkish banking sector.

INTRODUCTION

One of the many venues which have been adversely impacted by the financial crisis of 2008 is the global Foreign Direct Investment (FDI) inflows which experienced a sharp decline. Turkey is one of the emerging market countries that, in the several years prior to the financial crisis, have experienced a sharp increase in the amount of FDI entered into its banking sector (around USD 14 billion), where 12 foreign banks increased their shareholdings through acquiring majority shares in locally established banks. Most of the deals were between large and medium sized Turkish banks and leading banks in the global arena particularly with European origin.

The issue of whether increased FDI leads to better performing banks has been a debated research question. Many banks striving to increase their shares in the global arena have expanded their operations beyond the borders of their local...
markets. A driving force of such expansion and internationalization of the banking sectors was the liberalization of financial markets both in developed and developing countries. As in many developing countries, foreign banks in Turkey have the opportunity to gain a high market share due to low market value of banks and make profit due to less effective domestic competition compared to developed countries.

The Turkish financial market has been open to foreign institutions especially after the financial liberalization in the early 1980s when foreign firms became eligible to form partnerships with their Turkish counterparts and purchase 100% of their stake. However, foreign banks were not largely prevalent in the Turkish banking system until after the reforms, which were implemented following the 2001 financial crises. The Bank Regulation and Supervision Agency (BRSA) and State Banks Joint Management Board worked hard on a successful implementation of the reform programme, which reduced financial risk and strengthened the capital structure of Turkish banks allowing for increase in profits and growth. In particular, banks under the management of the Saving Deposits Insurance Fund (SDIF) in 2001 were merged under a single name and some of them were sold to foreign financial institutions.

Many reasons have been identified in the literature as factors attracting foreign investors into a banking sector. We suggest the regulatory changes in Turkey and high performance of some banks as couple of them. These cover:

- Reforms in the investment area.
- Equal treatment of domestic and foreign banks in Turkey.
- No limitations on foreign ownership of banks by the law, after the twin crises when Turkish government relaxed entry barriers for foreign investors.
- Stronger auditing and regulation compared to previous periods.
- Opportunity for foreign investors to take over Turkish banks is easier than in developed countries as Turkish banks are relatively small in size.
- Supporting the argument by with Kraft (2004), low level of competition in Turkey among foreign banks could be reasons of increased FDI.
- High profitability of some banks in the sector.
- Continuous high efficiency of some banks in the sector.

Moreover, Turkish banking sector has also provided one of the stronger responses to the recent crisis among the developing countries. One question is whether FDI had a significant impact on the renewed strength and the improved efficiency of the banking system. One channel of literature suggests that foreign banks are more efficient than domestic banks, on the other Berger et al. (2003) illustrated that efficiency is a pre-condition rather a result of FDI in banking markets. We aim to find out the answer whether efficiency increased with FDI or efficiency is a pre-condition attracting foreign investors to the Turkish banking sector in this chapter. More specifically, we aim to contribute to the literature by answering the following questions: 1) Which banks attract FDI in the first place? 2) Do the foreign-invested banks perform more efficiently than their domestic counterparts after the FDI? and finally 3) Does FDI have a positive impact on the banking sector as a whole?

The rest of the chapter is structured as follows. Section 2 presents an overview of the empirical literature. Section 3 introduces the methodological framework, the data and variable definitions followed by a discussion on empirical results in Section 4. Finally Section 5 concludes.