CHAPTER 1 : INTRODUCTION

This chapter introduces the research topic. It begins by providing some background information, for insight into the problem statement. The objective and the significant of the study, together with the research questions are in this Introduction chapter.

1.1 BACKGROUND OF RESEARCH

A growing body of empirical analyses suggests a strong positive link between the functioning of the financial system and economic growth, and there is substantial evidence to indicate that well-functioning financial intermediaries matter for growth (Levine, 2004). Throughout the decades there had been many episodes of bank crisis in many countries. Caprio and Klingebile (2003) presented information on 117 systemic banking crisis (defined as much or all capital being exhausted) in 93 countries, and 51 borderline and smaller (non systemic) banking crisis in 45 countries during the period 1970-2002, and showed that the estimated cost to the economy could be as high as 55% of GDP. In view of the key role that banks play on the economy, it is not surprising, that there is an extensive literature which focus on banks, a financial intermediary, which pool savings from individuals and allocate savings for investment purposes, including determining returns on savings and investment.

In this paper, we examine the performance of banks in four East Asia and six Latin America countries during the period 2003 – 2008, preceding the global financial crisis which started in 2007, from the US sub-prime mortgage crisis. Countries in both regions have had episodes of systemic banking crisis in the 1990s, and hence a healthy and efficient banking system is crucial for the economic well-being and stability of these countries. Bank performance relates to banking profit and interest margins or spreads, and the ten countries for purpose of this study are Malaysia, Thailand, Indonesia and Korea for East Asia; and Argentina, Brazil, Colombia, Mexico, Peru and Venezuela for Latin America. Standard financial performance ratios (internal determinants) and macroeconomic indicators and concentration (external determinants) are examined.

Demirguc-Kunt & Huizinga (2000) stated that banks profitability and bank interest margins drive a wedge between the interest rate received by savers on their deposits and the interest rate paid by lenders on their loans, and hence can be seen as indicators of the (in) efficiency of the banking system.

Profit is an important pre-requisite for future growth and source of finance for expansion (Goddard, Molyneux and Wilson, 2004). Given the environment in which bank operates, profit is a reflection on how banks are managed, the quality of bank's management, shareholders' behavior, competitive strategy, efficiency and risk management capabilities. Too high a banking profit, which could be due to strong market power may hamper the efficient intermediation of savings, while too low a profit may discourage investors' interest in banking activities. (Garcio-Herrero, Gavila and Santabarbara, 2006). A case in point is the decade of very high profit enjoyed by US banks, which did not prevent the current financial crisis. According to Tregenna (2009), although US banks enjoyed very high profit from early-mid1990s until the recent financial crisis, the profits were built on very shaky grounds and were unsustainable in terms of *inter-alia*, the real underlying quality of banks' assets and banks' degree of leverage. It seems that the US banks did not bolster their capital base with the profits enjoyed during the "fat years", which could have prevented or mitigated the financial crisis. The stability of banking system is maintained when there is sound and sustainable profit.

Interest rate spread (the difference between interest rate charged to borrowers and the rate paid to depositors) is a key variable in banks performance, reflecting the cost of financial intermediation (Brock & Suarez, 2000; Demirguc-Kunt, Laeven & Levine, 2004). High spread is indicator of inefficiency, which adversely affect domestic real savings and investment (Brock & Suarez, 2000). Feasible investment opportunities and therefore the growth potential of the economy is reduced as the expansion and development of financial intermediation is impeded, when interest spreads is too high, as potential depositors are discouraged by the low interest rates and financing for potential borrowers become limited (Barajas, Steiner and Salazar, 1999).

1.2 STATEMENT OF THE PROBLEM

The literature has long recognized the existence of a close link between financial development and economic growth (Singh et al., 2005). According to Levine (1997), the functions of a financial system include to facilitate the trading, hedging, diversifying, and pooling of risk, allocate resources, monitor managers and exert corporate control, mobilize savings, and facilitate the exchange of goods and services. In view of this, banks as financial intermediaries play a key role in the economy. Any banks failures, especially large banks, may cause a loss of public confidence, and unless the authorities intervene, will result in bank run, causing financial losses not only to that bank but perhaps other banks within that locality as well. This will have an adverse impact on the monetary system and economic stability.

Substantial research efforts has been devoted to understand the determinants of bank performance as a healthy and profitable banking sector is better able to withstand negative shocks and contribute to the stability of the financial system, and economic growth. Most studies on banking profit and interest margins have been conducted in the US and European banking institutions (Ho and Saunders, 1981 and Bourke, 1989) and to a certain extent, determinants of bank spreads in Latin America (Brock and Suarez, 2000), and at a much lesser degree, investigation on the determinants of banking performance in East Asia (Park and Weber, 2006). The global financial crisis has once again caused banks to be somewhat exposed and vulnerable to external shocks. Both East Asia and Latin

America share a common link, in that countries in these two regions experienced banking crisis in the 1990s. During the last two decades, banks faced many challenges including going through major transformation in its operating environment (liberalization, restructuring/recapitalization, privatization etc). To our knowledge, there is hardly any research which analyse banks performance between East Asia and Latin America. And given the recent global financial crisis, it would be appropriate to examine the determinants of banking profits and spreads in East Asia and Latin America during the period 2003 – 2008, following the crisis of the 1990s and the beginning of another crisis.

1.3 PURPOSE AND SIGNIFICANT OF RESEARCH

Demirguc-Kunt and Huizinga (1999) studied the determinants of bank interest margins of 80 countries, which included countries in East Asia and Latin America, during the period 1988-1985. The seminal research, although cover a wide range of countries, does not focus entirely or exclusively on countries in East Asia and Latin America. This study extends the existing literature by focusing on East Asia and Latin America, specifically four countries in East Asia and six countries in Latin America, using bank level data, macroeconomic indicators and concentration ratio to examine the determinants of banks performance for both regions. The period of study used, 2003 – 2008 is recent, taking into account challenges in a new millennium, while the shock of the 1990s to both regions would have passed. It also contributes to existing literature in understanding the underlying factors that affect banks performance in two different environments (geographical, political, legal and regulatory and economic environment). The health and performance of banks is important for a country's economic growth, and the conclusion drawn from studying the determinant of banks performance in East Asia and Latin America would be useful to stakeholders such as policy makers, regulators, central banks, government, bankers association and bank's management.

1.4 RESEARCH OBJECTIVES

This paper takes a closer look at the internal and external (macroeconomics and concentration) determinants of international banks profitability and interest margins of four East Asia countries (Malaysia, Indonesia, Thailand and Korea) and six Latin America countries (Argentina, Brazil, Colombia, Mexico, Peru and Venezuela) during the period 2003 – 2008. Both regions are emerging economies, and during the 1990s, experienced systematic banking crisis. East Asia in the later years of the 1990s (Indonesia, Korea, Thailand, Philippines and Malaysia, 1997/1998) and Latin America during the mid-1990s, starting in 1994 with Bolivia, Brazil, Mexico, and Venezuela, followed by Argentina and Paraguay in 1995, and Ecuador in 1996. The goal of this paper is to attempt to study the determinants of bank profits and interest margins in East Asia and Latin America.

1.5 RESEARCH QUESTIONS

This study seeks to examine the following research questions:

i) What are the determinants of bank profits and interest margins in East Asia and in Latin America, as a group ?;

ii) What are the determinants of bank profits and interest margins in East Asia and Latin America, as individual regions ?; and

iii) Whether the determinants of bank profits and interest margins in East Asia and Latin America region differs?

1.6 SCOPE OF STUDY

We focus only on the annual financial data of banks operating in Malaysia, Thailand, Indonesia, Korea, Argentina, Brazil, Colombia, Mexico, Peru and Venezuela during the period 2003 – 2008. This six-year period is reasonable, as it balances out the concern of too short or too long a period (Berger and Mester, 1997). Our sample is confined to Bankscope database for bank's characteristics and concentration ratio, while macroeconomic indicators are from the International Monetary Fund and World Bank database.

1.7 ORGANISATION OF THE STUDY

Chapter 1 provides the introduction to the research topic on "Determinants of Banks Performance in East Asia and Latin America". The remainder of this paper is organised as follows: Chapter 2 provides an overview of the banking systems in East Asia and Latin America; Chapter 3 review the literature; Chapter 4 describes the research methodology and the data; Chapter 5 presents and interprets the main results of the regression analysis; and finally, Chapter 6 concludes.