# CHAPTER I

# INTRODUCTION

## 1.1 Background and Problem Review

The measurement of the efficiency of financial institutions is an important factor in transitioning countries, with all of them facing at least one financial crisis. In most of these countries, the question of relative comparison of firms by size, type of ownership or date of appearance has been an issue. Is it beneficial to let new companies into the market? Should the domestic firms be sold to foreign companies? These questions and others continue to dominate discussions in many transitioning countries (Igor and Boris, 2001). In the early 1990s, a path towards deregulation and financial liberalization was introduced to Thailand with the acceptance of the Articles of Agreement of the International Monetary Fund (IMF). It required liberalization of capital flows, deregulation in the scope of the operation of financial institutions, and partial entry of foreign competitors in the domestic financial system (Bank of Thailand, 1998).

As a consequence of financial liberalization, foreign companies began to play a significant role in Thailand's financial services sector. Financial institutions were given more options and greater freedom to run their organizations. At that time, increased competition led several companies to specialize and split into several different units, such as financial consulting, leasing, factoring, and securities underwriting. However, liberalization, if not well-managed, can result in the elimination of initial gains or even in losses and this gave rise to doubts about the benefits of liberalization. In addition, the literature broadly suggests that foreign financial institutions outperform domestic companies in developing countries (Vichyanond, 1995).

This paper attempts to establish whether financial liberalization through financial sector deregulation and policies designed in Thai financial sector to increase the competitiveness of the financial system and to improve the efficiency of existing financial institutions. The data envelopment analysis (DEA), a non-parametric technique, was employed to analyze the efficiency of both financial institution production and intermediation processes, which are the two basic functions of financial institutions. As the strengths of DEA, it allows comparison of the relative efficiency of decision making units (DMUs) by using the efficient DMUs as benchmarks and then measuring the inefficiencies in input combinations in other DMUs relative to the benchmarks. The DEA model can handle multiple inputs and multiple outputs and doesn't require any specification of the function form. The sample of financial institutions used twelve commercial banks, twenty-four life insurance companies and eight finance companies that operated in the period of 1994 through 2003.

### 1.2 Statement of Problem/Research Question

Do financial institutions with foreign ownership outperform their domestically owned counterparts? Is competition necessary for improving efficiency?

### 1.3 Research Objectives

1.3.1 To evaluate the relative efficiency of domestic-owned financial institutions compared with foreign-owned before and after the financial crisis by a nonparametric methodology called data envelopment analysis (DEA).

1.3.2 To examine the difference in how domestic and foreign financial institutions perform in the same unfavorable economic environment.

### 1.4 Research Hypotheses

Hypothesis 1: Foreign-owned financial institutions have greater production efficiency than domestic-owned.

Hypothesis 2: Foreign-owned financial institutions have more intermediation efficiency than domestic-owned.

Hypothesis 3: Domestically-owned financial institutions improved in both production and intermediation efficiency after financial liberalization and deregulation.

### 1.5 Contribution

This study could benefit financial institution regulators who need to determine how the industry will respond to the introduction of new regulations, non-traditional entrants and world-wide competition; it could also help management concerned about the impact of ongoing structural changes on financial system operations.

### 1.6 Organization of the Study

The paper is organized into the following sections: Chapter 2 reviews the theoretical background of the study and the previous relevant studies of performance assessment on financial institutions, both foreign and domestic. Chapter 3 describes the data sources and methodology and discusses the measurement technique used to analyze efficiency. Chapter 4 details the descriptive statistics for both production and intermediation approaches for financial institutions. Finally, Chapter 5 provides a summary and recommendations for future research.