Credit risk of subsidiaries of foreign banks in CEE countries: Impacts of the parent bank and home country economic environment

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ABSTRACT

In this study, using dynamic panel data, we investigated the influences of the home country economic environment and parent bank condition on the credit risk of foreign banks in Central and Eastern European (CEE) countries. We concentrated on the international transmission of credit risk through the internal capital market of multinational banks. Our theoretical assumptions follow studies that document how the parent bank condition and home country macroeconomic environment affect lending in subsidiaries in CEE countries. However, our results go one step further. We provide evidence that these relationships are reflected in subsidiaries’ credit risk in CEE countries. Our results suggest that the size and profitability of the parent bank have negative influences, while the liquidity and credit risk of the parent bank have positive influences on the subsidiaries’ credit risk. Moreover, the GDP growth in the parent bank’s country has a negative effect on the credit risk of the subsidiary, while the lending rate and liquidity in the parent bank country cause growth in the credit risk. These results indicate a new channel of international risk transfer from parent bank countries to host countries through foreign-owned banks.

1. Introduction

The global financial crisis has put focus on the dilemma of the international transmission of financial shocks through multinational banks. The primary question following the crisis was as follows: will the foreign banks reduce credit supply in their host countries because of the problems in the home countries and their balance sheets? Numerous empirical papers confirm the effect of the macroeconomics in the home country and parent bank characteristics on the credit supply of the subsidiaries in host countries (Cetorelli & Goldberg, 2012; de Haas et al., 2012; Popov & Udell, 2012; de Haas & Horen, 2013; Ongena, Peydro, van Horen, 2013; de Haas & van Lelyveld, 2014; de Haas, Korniyenko, Pivovarsky, & Tsankova, 2014; Allen et al., 2013, 2014; Arakelyan, 2018; Temesvary & Banai, 2017). Profitability and liquidity from parent bank specifics and GDP growth from home macroeconomics were identified as the main determinants of subsidiaries’ credit supply in host countries.

This question was extremely important for the CEE countries. Namely, in the credit expansion period prior to the crisis, the leaders in CEE countries were the foreign-owned banks (Clarke, Cull, Peria, & Sánchez, 2003; Pazarbasioğlu et al., 2005; Aydin, 2008; Ong & Maechler, 2009). Therefore, it was extremely important to ensure a stable credit supply in CEE countries, which resulted in banks signing commitment letters in which banks committed themselves to maintaining credit supply in the countries of their
subsidiaries, the so-called Vienna Initiative.

At the same time, banks’ non-performing loans, NPLs, in CEE countries increased dramatically, and researchers started to investigate the determinants of NPLs. The results of empirical studies confirm the existence of three groups of determinants of credit risk: bank-specific, bank industry-specific and macroeconomic (Agoraki, Delis, & Pasiouras, 2011; Bock & Demyanets, 2012; Jakubík & Reininger, 2013; Skarica, 2014; Tanaskovic & Jandric, 2015). Despite the growing literature on the role of foreign banks in the credit supply in CEE countries and determinants of NPLs, research that considers the credit risk of subsidiaries of foreign banks has been rare (Gerl, 2007; Haselmann & Wachtel, 2007; Havrylchyk & Jurzyk, 2011). Their general conclusion is that the subsidiaries of foreign banks have lower NPL levels.

However, increased NPLs in banks’ balance sheets after the start of the crisis and the role of foreign banks in pre-crisis credit expansion have put the focus on a new research question about the role of foreign banks. Did the credit allocation of multinational banks toward CEE countries prior to the crisis encourage credit risk accumulation in CEE subsidiaries?

To our knowledge, all empirical studies tried to find the determinants of the credit supply through the internal capital market to detect the role of foreign banks in maintaining financial system stability in CEE countries. No single research study has considered the internal capital market as one possible channel of accumulation of credit risk in CEE countries. Therefore, we examine to what level the good, optimistic pre-crisis economic environment affected the credit risk of foreign subsidiaries in CEE countries. Did the banks focus on seeking yield in CEE countries encouraged by the economic environment in the home country and the business condition of parent banks?

Namely, in a situation of increased liquidity and low interest rates in the home country, the funds can be shifted to the subsidiaries in the host country to seek higher yields. Moreover, in an unfavorable economic situation in the home country, the profit of the parent bank can decrease, putting pressure on the subsidiaries to compensate for this loss and therefore relax credit standards and accept more risky projects.

Finally, the management of the subsidiaries must achieve target profitability; otherwise, the funds will be withdrawn through the internal capital market to a subsidiary in another host country, and they will not achieve their salary bonuses and maybe lose their positions. Can this encourage management to accept more risky projects?

To empirically investigate our research question, we constructed a data set that covers domestic and foreign-owned subsidiaries from 16 CEE countries and their parent banks. Previous research on CEE countries has considered three groups of credit risk variables: bank-specific, macroeconomic determinants in CEE and bank industry-specific determinants. We added two new groups of variables for foreign banks: parent bank specific and home country macroeconomics. We estimated our model by using two-step GMM estimators.

The period from 2000 to 2010 was considered. This period covers rapid credit growth in CEE countries prior to the crisis and the increase in NPLs after the outbreak of the crisis. The increase in NPLs until 2010 directly reflected banks’ credit decisions. After 2010, numerous new regulatory measures (Vienna Initiative I, II, etc.) were introduced. In addition, the multinational banks changed their credit policy after the outbreak of the crisis (Temesvary & Banai, 2017). The level of NPLs in later years was less a reflection of the managers’ decisions in banks and more influenced by the measures taken by regulators and supervisors to decrease NPLs in the economy. Therefore, we decided to concentrate our research on this period.

Our paper contributes to the existing literature in several aspects.

First, we upgraded the literature regarding credit risk in CEE countries. To our knowledge, this is first research of credit risk that considered two new groups of variables for foreign-owned banks: parent bank specific and the macroeconomics of the parent bank. However, several previous studies tried to investigate the role of foreign bank ownership (Uiboupin, 2005; Männasoo & Mayes, 2009; Cerutti et al., 2010; Maechler, Mitra, & Worrell, 2007; Agoraki et al., 2011; Drakos, Kouretas, & Tsoumas, 2016) by including the aggregate ratio of foreign banks in the banking system. The majority of these studies found evidence that a higher ratio of foreign banks in the banking system decreased the ratio of bank NPLs, regardless of bank ownership. With our bank-level approach, we investigated specifics of the parent banks and their macroeconomic environment, and we obtained more precise results about role of foreign banks in credit risk creation in CEE countries.

Second, our research follows numerous empirical studies that proved the influence of the internal capital market on credit supply in CEE countries, i.e., the importance of parent bank specific and macroeconomics of the parent bank on subsidiary credit supply. However, we go one step further. We explore the consequence of credit allocation of multinational banks prior to the crisis for credit risk in CEE countries. We confirm that both groups of variables also have a significant influence on credit risk. However, we found that all of the determinants that increase credit growth do not increase credit risk. We provide evidence that the parent banks’ profitability and size decrease credit risk. However, parent bank liquidity and credit risk increase the credit risk of subsidiaries in CEE countries. In addition, from the macroeconomic variables in the parent bank country, liquidity and interest rates increase credit risk, while the GDP growth decreases the credit risk of subsidiaries in CEE countries. All the above indicates that the specific situation of the parent bank or home macroeconomic situation will encourage managers to accept more credit risk in CEE countries.

Third, we provide arguments and evidence for why existing models about foreign bank risk-taking (Drakos et al., 2016; Jeon et al., 2016; Ashraf & Arshad, 2017) in emerging countries cannot always be suitable for CEE countries.

The role of foreign banks in CEE countries has its specific. In CEE countries, foreign banks dominate in the banking system, and therefore, they are not faced with information disadvantages as in other emerging countries. CEE countries are former communist countries where managers of domestic banks had less knowhow about doing business in the market economy. All of that indicates that foreign banks were at advantage in the markets of CEE countries and therefore could pick the best clients (Degryse, Havrylchyk, Jurzyk, & Kozak, 2012). Therefore, they should be less risky.

Additionally, foreign banks in emerging countries are better capitalized than domestic banks (Claessens & van Horen, 2012).
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