



Foreign bank entry, credit allocation and lending rates in emerging markets: Empirical evidence from Poland

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ABSTRACT

Earlier studies have documented that foreign banks charge lower lending rates and interest spreads than domestic banks. We hypothesize that this may stem from the superior efficiency of foreign entrants that they decide to pass onto borrowers (“*performance hypothesis*”), but could also reflect a different loan allocation with respect to borrower transparency, loan maturity and currency (“*portfolio composition hypothesis*”). We are able to differentiate between the above hypotheses thanks to a novel dataset containing detailed bank-specific information for the Polish banking industry. Our findings demonstrate that banks differ significantly in terms of portfolio composition and we attest to the “*portfolio composition hypothesis*” by showing that, having controlled for portfolio composition, there are no differences in lending rates between banks.

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1. Introduction

High foreign participation in the emerging banking markets has led to a heated debate on the benefits and costs of foreign bank entry for the stability and efficiency of the banking systems, as well as for borrowers. In this paper we focus on lending rates, which reflect the costs of using the financial system by borrowers. High lending rates can become prohibitive to many safe customers, blocking access to finance and hindering economic growth. Most empirical studies find that foreign banks on average charge lower lending rates and have lower spreads than domestic banks. For instance, Martinez Peria and Mody (2004) study Latin American countries during the late 1990s and find that foreign banks have lower spreads than domestic banks and takeover banks have higher spreads than greenfield banks. Claes and Hainz (2007) argue that foreign banks can undercut domestic banks' lending rates owing to their better screening skills.

The empirical findings quoted above can have two plausible explanations. On the one hand, foreign banks could charge lower lending rates because they have lower operating costs. There is a considerable evidence that foreign institutions are able to overcome cross-border disadvantages (distance, monitoring costs, differences in institutional environment, language and culture) and operate more efficiently than their domestic competitors in emerging economies (see e.g. Berger et al., 2000; Bonin et al., 2005; Chen and Liao, 2011; Havrylchyk and Jurzyk, 2011; Weill, 2003). If foreign banks choose to pass on their higher efficiency to borrowers in order to gain market share, this “*performance*” effect is expected to be identical for all borrowers (“*performance hypothesis*”).¹ It should be stressed that if foreign banks are more efficient than other banks but rely on this cost advantage to extract rents from borrow-

¹ This hypothesis is related to the Berger et al. (2000) global advantage hypothesis. Foreign entrants may also raise revenues through superior investment or risk management skills, by providing better service quality/variety that some customers prefer, or by obtaining diversification of risks that allows them to undertake higher risk-higher expected return investments. Further, foreign banks in transition and developing economies additionally benefit from their better access to international capital markets and funding from their parent companies. This diminishes their cost of funds, which in turn should be translated into lower lending rates, benefiting borrowers. Moreover, foreign banks might enjoy lower cost of deposits due to their superior reputation.

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ers instead of charging lower lending rates, we would interpret this as the rejection of the “performance hypothesis”.

Alternatively, foreign banks could charge lower lending rates if they supply credit to more transparent and less risky borrowers. Dell’Ariccia and Marquez (2004) argue that foreign banks face large information disadvantages and, thus, prefer to target more transparent clients (relying on transactions-based lending), whereas domestic banks are better placed to lend to firms based on soft information (relationship lending) (see also Althammer and Haselmann, 2011; Detragiache et al., 2008; Gormley, 2011). Sengupta (2007) shows that foreign entrants exploit their cost advantage by offering collateralized loans to large transparent firms whereas incumbent banks retain more risky borrowers. Even if foreign banks are able to collect soft information, they might have more difficulties or be less willing to communicate it to their headquarters. Stein (2002) argues that organizations with more hierarchical structures are more likely to rely on hard information as opposed to organizations with flatter structures. The reason is that flatter organizations have better control and information on their managers, and thus can afford to give them more discretion, which allows them to use soft information. This modeling has been extended to large banks by Berger et al. (2005) and can further be applied to foreign banks, which belong to large multinational banking groups, and where communication of soft information is obstructed not only by the hierarchy, but also by cultural, institutional and linguistic barriers. Numerous empirical studies support these theories and find that foreign banks lend less to opaque borrowers, such as small and medium enterprises, than domestic banks (Clarke et al., 2005, 2006 for Latin America; Berger et al., 2001, Gormley, 2010 for India; Giannetti and Ongena, 2009, 2012 for Central and Eastern Europe; Mian, 2006 for Pakistan).

Credit allocation can also differ in other dimensions. Foreign banks could extend more short-term loans to solve asymmetric information problems as well as to secure “hot” money that is readily retracted during crises (Rodrik and Velasco, 2000; Popov and Udell, 2010).² In addition, foreign banks could supply more foreign currency loans because they rely less on domestic deposits and have better access to the international capital markets and financing from the parent banks (see Brown et al., 2008; Beer et al., 2010; ECB, 2006; Farnoux et al., 2004; Sorsa et al., 2007). Since loans to transparent borrowers and in foreign currency have lower interest rates than other types of loans, the observed lower lending rate of foreign banks could be easily explained by a different loan allocation (“portfolio composition” hypothesis).³

In our paper, we distinguish between the “performance” and the “portfolio composition” hypotheses and, to the best of our knowledge, this is the first to attempt to do this. We are able to differentiate between the two hypotheses thanks to a unique database on all Polish commercial banks that includes detailed information on several dimensions of credit allocation – lending rates, amounts of loans, and amounts of nonperforming loans to different borrower types and in different currencies and maturities. We think that Poland provides an excellent testing ground for our hypotheses because it has the largest banking sector in Central and Eastern Europe. Since the share of foreign investors in Polish banks amounts to 74%, this provides us with a large number of foreign banks and at the same time leaves us with a much higher number of domestic banks than in most other Central and Eastern European countries (CEECs). Furthermore, as we will argue below, the institutional

environment of Poland is close to the average of other emerging markets, and can therefore be considered as representative.

We differentiate between greenfield banks (foreign banks that enter via greenfield investment) and takeover banks (foreign banks that acquire an existing domestic institution), because theory suggests that the impact of foreign banks’ behavior depends on their mode of entry (see e.g., Claeys and Hainz, 2007). Indeed, both hypotheses, “performance” and “portfolio allocation”, could be strongest for greenfield banks, because they have a larger efficiency advantage and a larger informational disadvantage relative to domestic and foreign takeover banks. The latter inherit inefficient and non-transparent organizational structure and could be burdened by nonperforming loans, but they also obtain the personnel and access to loan information that may help them overcome informational asymmetries.

Our findings can be summarized as follows. We find that portfolio composition of banks in terms of borrower opacity, loan maturity and currency differs significantly depending on bank ownership and mode of entry. Most importantly, having controlled for these differences, foreign banks do not charge lower lending rates than their domestic counterparts. This result contrasts with Martinez Peria and Mody (2004) and Claeys and Hainz (2007) that suffered from omitted variable bias and, thus, were not able to control for the portfolio composition of banks. Finally, we confirm theoretical predictions of Dell’Ariccia and Marquez (2004) that the entry of foreign banks via greenfield investment leads to the reallocation of lending by domestic banks to more opaque borrowers increasing the riskiness of their portfolios.

The rest of this paper is organized as follows. Section 2 presents our data. Sections 3 and 4 describe our empirical findings on portfolio allocation and loan rates, respectively. Section 5 deals with the impacts of foreign entry on domestic banks. Section 6 concludes.

2. Polish banking industry and data

We test our hypotheses using a novel dataset that was kindly provided by the National Bank of Poland. It contains quarterly information on 110 Polish banks⁴ between December 1996 and December 2006. In addition to standard information from balance sheets and income statements, it contains data on interest income, amount of granted loans, and nonperforming loans for two borrower types: private firms and individual entrepreneurs.⁵ This allows us to examine lending volumes and lending rates that banks with different ownership structure charge their transparent and non-transparent borrowers.⁶ Our data gives us a unique opportunity to construct banks’ portfolio shares, interest rates, market shares, bank concentration measures, and nonperforming loans for each borrower type separately.

In principle, transparent firms should have reliable financial statements, long credit history, and good collateral, all of which helps the bank to evaluate borrower’s creditworthiness. Private

⁴ We define a bank as Polish if it is registered in Poland and the National Bank of Poland collects information on it.

⁵ The distinction between private firms and individual entrepreneurs is grounded in Polish law. A borrower is classified as a “private firm” if the firm is owned by private investors (either entirely, or where the private share exceeds 50%), and is either subject to commercial law or is subject to civil law and employs more than 9 workers. Additionally, such firms have to comply with accounting regulations that require full bookkeeping. “Individual entrepreneurs (for short, entrepreneurs)”, in contrast, are small firms employing up to 9 workers, subject to civil law, and using simplified accounting procedures.

⁶ We also have information on three other groups of borrowers: state-owned enterprises, farmers and households. We decided not to use these three groups because they cannot be unambiguously ranked in terms of transparency and, hence, we have opted to rely on data for only two groups – large private firms and individual entrepreneurs.

² For example, Dooley and Shin (2000) argue that foreign creditors’ run from Korean banks triggered the crisis in Korea in 1997.

³ Our two hypotheses are not mutually exclusive. Lower lending rates of foreign banks might reflect both performance and portfolio composition effects.

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