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What drives foreign expansion of the top 100 multinational banks? The role of the credit reporting system

Hsiangping Tsai [a,*], Yuanchen Chang [b], Pei-Hsin Hsiao [a]

[a] *Department of Finance, Yuan Ze University, Taoyuan, Taiwan*
[b] *Department of Finance, National Chengchi University, Taipei, Taiwan*

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ABSTRACT

This study explores how information costs, proxied by characteristics of credit reporting systems, affect the foreign expansion of the top 100 multinational banks. We find that banks prefer to expand operations in countries where private credit bureaus exist or where the credit reporting system is of better quality. This preference is particularly strong for banks' branch decisions. Furthermore, banks prefer subsidiary entry only in countries where private credit bureaus exist with better credit information quality. Overall, our results indicate that banks are attracted to countries where the credit reporting system helps reduce banks' information costs.

1. Introduction

Motivated by the trend of globalization and internationalization, banks generally expand abroad to support the international business of existing clients and to develop new businesses in host countries. Researchers have described what drives multinational banks' foreign expansion. Clarke et al. (2003) show that banks tend to follow their customers abroad and that larger banks are more likely to expand abroad, but restrictions on foreign direct investment may reduce bank incentives to enter other countries. Furthermore, banks prefer expanding to countries with a larger economic size (Brealey and Kaplanis, 1996), and they are less likely to operate in countries far away from their home country (Focarelli and Pozzolo, 2005).

Another strand of literature shows that regulatory barriers and information costs are the main features driving bank activities. For example, Buch (2003) presents that deregulation encourages international banking activities, and to reduce information costs banks generally expand operations to countries that are closer and to countries that speak the same language. Moreover, when credit bureaus exist to facilitate exchanges of information among banks, the information costs of banks drop (Pagano and Jappelli, 1993). The reduced information costs tend to increase bank lending, reduce bank risk level, increase credit availability to firms, and cut the credit costs of firms (Jappelli and Pagano, 2002; Brown et al., 2009; Houston et al., 2010).

We extend the literature to investigate how information costs affect the location choices of banks as they expand their foreign operations. In countries with a credit reporting system, it is easier for banks to collect information and evaluate the creditworthiness of potential borrowers. Thus, the cost of gathering information on borrowers may decrease. This is especially crucial to foreign banks that are new to the market and are not familiar with local borrowers. With access to the credit history of potential borrowers from the credit reporting system, foreign banks can identify potential customers with good payment histories and avoid making loans to borrowers with late payments or defaults. Therefore, we expect lenders' information costs to be lower in countries where a credit reporting system exists or in countries where credit reports provide better borrower information in terms of timeliness, accuracy, and completeness. To directly test the importance of information costs on banks' foreign expansion, we explore whether bank foreign operations are more likely to be located in countries where a credit reporting system exists

* Corresponding author. Tel.: +886 3 463 8800x2672; fax: +886 3 435 4624.
E-mail addresses: hptsai@saturn.yzu.edu.tw (H. Tsai), yccchang@nccu.edu.tw (Y. Chang), s967224@mail.yzu.edu.tw (P.-H. Hsiao).

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and where better borrower information is available from the credit reports.

Using data on the foreign branches and subsidiaries of the top 100 multinational banks from 2001 to 2007, we document that the decision to enter or expand operations in a given country is affected by characteristics of the credit reporting system in that country. First, we show that banks are attracted to countries where credit reporting agencies exist. Second, banks are more attracted to countries with private credit bureaus than countries with public credit registries. Third, our results indicate that banks prefer expanding to countries where the credit reporting system provides better quality of credit information in terms of timeliness, accuracy, and completeness.

To our best knowledge, this is the first paper testing directly whether information costs affect the foreign expansion of banks, while the existing literature presents evidence that credit bureaus tend to reduce information costs for banks with positive effects for the real economy in terms of an increase in banking lending, lower rates for firms, and a decrease of bank riskiness (Pagano and Jappelli, 1993; Jappelli and Pagano, 2002; Brown et al., 2009; Houston et al., 2010). Our results further suggest that by reducing bank information costs, the credit reporting system in a host country plays a role in attracting foreign bank operations.

The remainder of the paper proceeds as follows. Section 2 presents the literature review and hypothesis development. Section 3 explains how we construct our datasets. Section 4 describes the model specifications. Section 5 reports our empirical results and Section 6 offers conclusions and recommendations.

2. Literature review and hypothesis development

2.1. Foreign expansion of banks

Earlier studies on the development of multinational banks examine US banks' cross-border activities and the entry of foreign banks into the US (Goldberg and Johnson, 1990; Parkhe and Miller, 1998). According to these studies, banks are more likely to develop foreign operations when the host countries have a high gross national product or international trade volume and are less likely to develop them when the host countries put stringent regulations on bank entry or when the host countries exhibit higher country risk.

Some studies have focused on the foreign activities of non-US banks. In an analysis of the foreign expansion of German banks, Buch (2000) shows that bank foreign activities are positively related to German firms' overseas activities, which means German banks follow clients to expand abroad. By examining foreign bank operations in Australia, Williams (1998) presents that larger foreign banks are more likely to obtain banking licenses in Australia and they seem to have higher interest margins and fees than local banks. Some studies explore the foreign operations of banks around the world. Both Brealey and Kaplanis (1996) and Focarelli and Pozzolo (2005) examine foreign operations of large international banks and their results confirm the previous findings that banks tend to expand to host countries which have a high degree of integration with the home country, and that banks are less likely to have foreign operations in countries far from the home country. Focarelli and Pozzolo (2005) further provide results that differentiate between a bank's decision to establish branches or subsidiaries. They show that banks prefer to set up subsidiaries in countries with higher profit opportunities and fewer regulatory restrictions, but prefer to establish branches in financial centers.

2.2. Effects of regulatory restrictions on bank foreign expansion

Research focus has recently turned to examine the regulation effects on the foreign operations of international banks.[1] Buch (2003) argues that regulatory barriers may influence the international activities of banks and tests how deregulation drives commercial bank activities in the European market. These results suggest that deregulation (the implementations of the Basel Capital Accord and EU Single Market) tends to have a positive impact on lending to OECD countries and intra-EU asset holdings, and capital control may reduce cross-border lending. Bertus et al. (2008) show that foreign bank presence is higher in countries with less market discipline, but is unrelated to supervisory oversight and capital regulatory oversight. Using data on the world's top 100 banks, Cerutti et al. (2007) examine regulatory effects on the organizational forms of bank foreign operations. They show that more branch restrictions, required either by home or host country regulators, result in fewer foreign branches. In addition, banks choose foreign subsidiaries instead of branches in countries with more requirements on bank entry and in countries with lower corporate taxes. However, banks seem to have no preference on organizational forms in host countries where stringent restrictions on bank activities exist.

2.3. Effects of credit reporting systems on bank activities

Some researchers examine how credit reporting systems reduce bank information costs and the interaction between credit reporting agencies (credit bureaus) and banks. Pagano and Jappelli (1993) consider a theoretical model in which banks in a country establish a credit bureau to share information about the quality of potential borrowers. Their results suggest that banks have the greatest incentive to establish credit bureaus when they experience the lack of a previous relationship and the lack of information on many customers, and this is confirmed by an empirical analysis using data on consumer credit markets in 14 OECD countries. They also suggest credit bureaus may increase lending activities by attracting safe borrowers who originally stay out of the market, because of severe information asymmetry problems.

Credit bureaus collect borrower information from member banks and other sources (public registers, tax authorities, courts, financial reports, etc.), maintain a database containing credit files for each borrower, and provide credit reports as member banks request. By facilitating the exchange of borrower information among banks, credit bureaus may have the following impact on banking activities (Jappelli and Pagano, 2002). First, credit bureaus make it easier for banks to exchange borrower information, such as borrower characteristics, credit history, and borrowing details (loan size granted, loan type, etc.). This reduces bank information costs, improves bank knowledge of borrower credit worthiness, and enhances a bank's ability to predict the probability of borrower repayment. Second, credit bureaus can be viewed as a mechanism to discipline borrowers. Borrowers understand that member banks of the credit bureau will refuse to lend to borrowers with bad credit and thus are more willing to repay loans.

Credit reporting agencies around the world can be classified into public and private types. In some countries, there exists a public credit registry which is managed by the central bank or

[1] Some researchers consider the relationship of bank regulation and foreign bank entry in different ways. For example, Lensink et al. (2008) link the effect of foreign ownership on bank efficiency to the quality of institutions for the home and host country. They show that foreign ownership reduces bank efficiency, but this negative effect is less pronounced when a host country has good institutions and when there is higher similarity on the quality of institutions between the home and host country. On the other hand, Lehner (2009) models the entry of multinational banks and shows that regulators may permit entry only when foreign banks have abilities to screen borrowers and that regulators in countries with less competitive markets are more likely to deny foreign bank entry.