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Credit risk determinants: Evidence from a cross-country study



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ABSTRACT

This paper applies a dynamic panel data approach to examine the determinants of non-performing loans (NPLs) of commercial banks in a market-based economy, represented by France, compared with a bank-based economy, represented by Germany, during 2005–2011. The paper is motivated by the hypothesis that macroeconomic and bank-specific variables have an effect on loan quality, and that these effects vary between different banking systems. The key question discussed is which credit risk determinants are important for both countries. The results indicate that except for the inflation rate, the set of macroeconomic variables used in the paper influence the NPLs of both economies. This result is explained by the fact that both economies belong to the same euro area. Additionally, our study finds that compared to Germany, the French economy is more susceptible to bank-specific determinants. This highlights the impact of the type of economy (bank-based or market-based) on credit risk.

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1. Introduction

The recent financial crisis has attracted increasing attention to the consequences that banking system instability can have on an economy (Agnello and Sousa, 2011). Hence, it has inspired academics to examine in greater detail the factors that may trigger a banking crisis. In this context, exploring the factors that affect credit problems is an important issue for regulatory authorities in order to maintain financial stability, and to enable banks to pursue responsible management.

A banking crisis may occur following volatility in the macroeconomic environment (Festic et al., 2011; Louzis et al., 2012; Nkusu, 2011) such as a fall in growth, or increases in levels of unemployment, interest rates, and inflation. Llewellyn (2002) also observes that, among other issues, banking system problems are commonly preceded by the accumulation of structural weaknesses in the economy and the financial system, hazardous banking practices, incentive structures, and moral hazard. Nevertheless, it seems that a banking crisis is primarily caused by banks' incapacity to satisfy their payment obligations, a situation that is essentially triggered by impaired loans on their balance sheets. This is why Castro (2013) emphasizes that one must examine banking credit risk problems that take the form of non-performing loans (NPLs) before looking at the causes of a banking system crisis. Similarly, Reinhart and Rogoff (2010) point out that NPLs can be used to mark the beginning of a banking crisis.

Although credit risk is affected by common factors in most countries that experience a banking crisis, each country has specific elements. Consequently, this study tries to examine credit risk determinants across two European countries: France and Germany. By exploring credit risk in these countries during the period 2005–2010 (see Fig. 1), one can note that the French banking system had a greater credit risk than the German.

The choice of France and Germany is not arbitrary. Although both countries belong to the Organization for Economic Co-operation and Development (OECD), they present interesting differences that have motivated us to compare them. Essentially, they have different financial systems: France seems to have a market-based financial system, while Germany has a bank-based one. Even though the market-based financial system is usually associated with Anglo-Saxon countries, and the bank-based financial system is attributed to continental Europe, France is considered to have a market-based economy.¹ In this regard, we base the classification of both countries on categories that are consistent with existing literature (for example, Allard and Blavy, 2011; Baliga and Polak, 2004; Koeter and Wedow, 2010). These studies find that amongst continental European countries, the French financial system seems more like a market-based one than a bank-based one. In financial terms, France is not that far removed from countries such as the UK and the US, and is not that close to countries such as Germany. Further, of France and Germany, the former was the first to deregulate its financial market: banking deregulation occurred in the mid-1980s in France and in the early 1990s in Germany.

The present study aims to contribute to the loans problem literature in three ways. First, our study is the first that provides an in-depth comparison of the bank credit systems of France and Germany. Both countries are generally studied as part of the same group, namely European or OECD countries (Castro, 2013; Rinaldi and Sanchis-Arellano, 2006) and rarely compared to each other. Earlier credit risk comparative studies also consider countries that belong to different continents (Ali and Daly, 2010). Second, this paper presents a comparative study of all the factors that contribute to banking credit risk. Our aim is to identify the most significant bank-specific and macroeconomic environmental factors that lead to different credit risk intensities in both countries. Third, the paper considers two different categories of determinant, specifically macroeconomic (systematic) and microeconomic (non-systematic). In the majority of empirical studies on bank credit risk determinants, either macroeconomic or bank-specific determinants are considered. Only a small number of studies have used both types of determinant (Louzis et al., 2012; Salas and Saurina, 2002).

By employing a dynamic panel data approach to the French and German banking systems for the period 2005–2011, our findings indicate that for both of these countries, credit risk, measured by NPLs,

¹ In a professional seminar "Understanding Financial Markets," Paris-Dauphine University, Masters 111 and 211, the authors note: "When observing data concerning the relative size of corporate bond and equity markets in the OECD countries we can however notice that France isn't that far from countries like the UK or the US and isn't that close to countries like Germany."

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