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Journal of Banking & Finance 31 (2007) 3742–3760

Journal of BANKING & FINANCE
www.elsevier.com/locate/jbf

Asymmetric information and the mode of entry in foreign credit markets

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Received 12 October 2005; accepted 22 January 2007
Available online 31 March 2007

Abstract

In a newly liberalized credit market, foreign banks with cost advantages are likely to be less informed than domestic banks that hold information on credit risks. These relative advantages may generate incentives for a foreign bank to negotiate acquisition of a domestic bank in order to capture information endowments. However, if it is difficult to assess the value of information held by banks, the foreign bank will face important choices about the optimal mode of entry and what acquisition price to pay. These choices have implications for the survival of domestic banks and how capital is allocated after liberalization.

JEL classification: G21; D82

Keywords: Foreign entry; Bank competition; Information

1. Introduction

The recent liberalization of financial markets has led to an increase in the presence of foreign banks in many countries. In several Latin American and Eastern European countries for example, foreign controlled banks now hold more than half of the banking assets (Berger et al., 2000; Clarke et al., 2003; Crystal et al., 2001). In some of these markets the increase in foreign ownership has been nothing short of dramatic, such as in Mexico,

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0378-4266/$ - see front matter
doi:10.1016/j.jbankfin.2007.01.016

where by 2002, nearly 80% of Mexico's commercial banking assets were controlled by foreign banks, up from a mere 20% in 1998 (Bubel and Skelton, 2002). The increased participation of foreign banks in these economies raises questions about the survival of domestic institutions, the impact of foreign entry on market interest rates, and the efficiency implications of increased competition. While a growing number of empirical studies have begun to address these questions, there have been fewer attempts to formally model the phenomenon.

The aim of our paper is to contribute to the literature on foreign bank entry, with an emphasis on applications to emerging economies. With this in mind, we develop a theoretical model where a foreign bank faces a choice about mode of entry into a domestic credit market containing informed incumbent banks. The motivation for entry stems from an assumption that the foreign bank operates at a lower cost than domestic banks in emerging market economies. This assumption is supported by the empirical research of Chang et al. (1998), Claessens et al. (2001), and DeYoung and Nolle (1996). Endowed with a lower cost of capital, we allow the foreign bank to enter either through de novo investment in the host country or alternatively, by acquiring an existing domestic bank.

Under de novo entry, we assume the foreign bank enters the domestic market by establishing a new bank alongside existing incumbent banks. While the foreign bank holds a cost advantage, we assume the domestic banks hold an advantage in that they are better informed about the domestic market.[1] In a related paper, Dell 'Ariccia and Marquez (2004) explain how relative advantages in cost and information determine whether or not a foreign bank enters a market containing incumbents. However, the authors focus on entry through de novo investment and do not consider acquisition. It is in this context that we find a key motivation for our study. Our premise is that a low cost foreign bank and a well informed domestic bank should face incentives to trade information endowments. In fact, if one allows such trade, one might expect a foreign bank to be most interested in segments of the domestic market where banks have the greatest information advantages over competing institutions.

To formalize this idea, we assume that banks can trade information if they negotiate a successful acquisition.[2] The acquisition process is complicated by the presence of multiple domestic banks that are heterogeneous in terms of their information endowments. In formulating an optimal acquisition strategy, we assume the foreign entrant faces uncertainty regarding the specific value of information held by a target domestic bank. This assumption is based on evidence such as Morgan (2002), who finds that agencies like Moody's and S&P disagree most when it comes to rating banks in comparison to other types of firms. The inconsistencies are attributed to the nature of the financial assets held by banks, such as loan portfolios, where the argument is that "...lending to opaque borrowers may cause opaque banks".

In another related paper, Claeys and Hainz (2004) study how interest rates vary according to whether a foreign bank enters through de novo investment or acquisition. Besides

[1] See Kane and Malkiel (1965) and Fama (1985) for discussion on banks' information advantages. Based on this assumption papers such as Sharpe (1990), Rajan (1992), and Peterson and Rajan (1995) have examined how information asymmetries and competition among banks shape market interest rates.

[2] The idea that acquisition may be an effective means of trading information endowments has been pointed out in earlier papers, such as Dell'Ariccia (2001) and Marquez (2002). Our contribution is to formalize this thinking by allowing the mode of entry to be endogenous.