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# Foreign bank lending and information asymmetries in China: Empirical evidence from the syndicated loan market

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ABSTRACT

This paper considers whether information asymmetries affect the willingness of foreign banks to participate in syndicated loans to corporate borrowers in China. We analyze how ownership concentration, which influences information asymmetries in the relationship between the borrower and the lender, exerts an impact on the participation of foreign banks in syndicated loans granted to Chinese borrowers in the period 2004–2009. We observe that greater ownership concentration of the borrowing firm does not positively influence participation of foreign banks in the loan syndicate. We conclude that information asymmetries are not exacerbated for foreign banks relative to local banks in China.



## 1. Introduction

The last three decades have witnessed impressive growth in China, yet the prevailing view persists that the Chinese financial system suffers from serious problems that could hamper future economic growth. The Chinese financial system, as noted by Allen, Qian, Qian, & Zhao (2009), "is currently dominated by a large, but under-developed, banking system." Specifically, this inefficient banking industry plays an oversized role relative to the financial markets in financing the economy. This is particularly true for major state-owned banks (Berger, Hasan, & Zhou, 2009a; Lin & Zhang, 2009), and as a result, private-sector borrowers often find themselves at the back of the line when seeking access to credit.[1] Moreover, despite the huge decline in nonperforming loan (NPL) ratios over the last decade,[2] recent credit growth has renewed fears of an uptick in NPL ratios in the banking industry (OECD, 2010).

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[1] While China's total bank credit ratios are high (between 100% and 120% of GDP over the past decade) Allen et al. (2009) observe that the size of Chinese banking industry in terms of total bank credit to non-state sectors amounted to just 31% of GDP in 2005. This is considerably less than average of 78% of GDP in the group of countries analyzed by La Porta et al. (1998), but well in line with the share found in major emerging economies (32% of GDP).

[2] Nonperforming loans (NPLs) equaled about 7.3% of GDP in China in 2005. This is far less than the 22.5% NPL ratio of 2000, but considerably higher than the 0.7% NPL ratio in the US in 2005 (Allen et al., 2009). According to China's Banking Regulatory Commission, total outstanding NPLs in the country's banking sector (including policy banks, loan companies and postal savings banks) in 2009 amounted to 1.53 trillion yuan, or about 4.5% of GDP.


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These problems are due in part to the state's strong presence in the banking industry. State involvement in management of Chinese banks, in turn, leads to other problems such as toleration of overstaffing or lending decisions that are guided more by public policy than commercial criteria (Podpiera, 2006).[3]

One can imagine a number of ways the presence of foreign banks in the Chinese financial system might help alleviate this situation. Greater foreign bank lending might enhance bank credit both quantitatively and qualitatively. Foreign banks might also be more averse to making bad loans as they are not pursuing public policy goals and lack the non-economic motivations of state policymakers when allocating credit. The establishment of foreign banks in China could also conceivably enhance banking sector performance overall as it has been shown that foreign banks are more efficient than local banks (Berger et al., 2009a), mitigate the diseconomies of diversification in the Chinese banking industry (Berger, Hasan, & Zhou, 2010) and can enhance profitability in the Chinese banking sector (e.g. Garcia-Herrero & Santabarbara, 2008).

In principle, China's accession to the WTO in 2001 opened the Chinese banking system up to foreign investors in two ways. First, it meant foreign banks would be allowed to operate directly through the branches and subsidiaries they themselves established. This expansion was to be facilitated during a five-year transition period in line with China's WTO commitments. Second, foreign strategic participation in domestic banks was allowed in 2003. The foreign strategic investment rules issued by China's Banking Regulatory Commission, however, continue to limit the participation of foreign banks in local banks to a minority stake. The reality today is that the overall market share of foreign banks in China's banking sector remains quite low (OECD, 2010).[4]

Even if direct lending is difficult, foreign banks can grant credit to Chinese companies via the syndicated loan market. Here, foreign banks play a major role. As in other emerging economies in Asia, China's manager league tables in the syndicated loans market were initially foreign dominated and a substantial proportion of loans were issued in foreign currency. Since the global financial crisis and collapse of the market, this tendency (at least temporarily) has been reversed (Chui, Domanski, Kugler, & Shek, 2010). With the market rebound, the China Banking Association reports that foreign banks accounted for 7.11% of the volume of loans to companies in 2009.

The key determinant for foreign banks in the financing of the Chinese economy, however, may be the degree of information asymmetries in the bank–borrower relationship relative to local banks. This is a major issue in assessing the prospects for expansion of foreign bank lending in China[5]. At first glance, it would appear local banks have an information advantage. They have easier access to local firm-specific information and likely benefit from a better understanding of the local accounting documents. On the other hand, foreign banks may have informational advantages or at least can get more out of information if they can acquire it from local banks as they have superior skills in monitoring and risk analysis of loans. Indeed, it has been shown that foreign banks operating in emerging economies often leverage their efficiency advantages based on their superior expertise and technology (for China, see e.g. Berger et al., 2009a; Berger, Hasan, & Zhou, 2009b; for European transition countries, see e.g. Weill, 2003 or Bonin, Hasan, & Wachtel, 2005).

This paper investigates information asymmetries between borrowers and lenders by focusing on the syndicated loan market in China. Numerous researchers have noted that syndicated loans provide a relevant laboratory for analyzing information asymmetries between borrowers and lenders as they can influence the syndicate structure (Bosch & Steffen, 2010; Lee & Mullineaux, 2004; Sufi, 2007). Our goal here is to see whether information asymmetries increase or reduce participation of foreign banks in syndicated loans. If foreign banks suffer from informational disadvantage relative to local banks, we would expect them to base their lending decisions on characteristics of borrowing firms known to minimize agency risks. Syndicated loans granted to firms with greater agency conflicts would thus be expected to have a lower proportion of foreign banks in the pool of participant banks.

We start by considering ownership concentration as a signal used by foreign banks to detect borrowers with less agency costs. In the context of poor protection of investor's rights, two agency conflicts emerge in Chinese listed firms. First, managers are weakly monitored by shareholders. Second, the controlling shareholder can extract private benefits from the firm. These two types of agency conflicts come at the expense of other stakeholders, notably creditors of the firm. We argue that ownership concentration reduces these two types of agency conflicts. First, monitoring of managers is increased when ownership is concentrated. Shleifer and Vishny (1997) observe that ownership structure can be used as a signal to solve an information asymmetry problem. Jensen and Meckling (1976) note that agency costs can arise from conflicts of interest between categories of agents inside the firm. When control is distinguished from ownership in the firm, the manager can use private information to extract private benefits at the expense of other stakeholders.

Shleifer and Vishny (1986) point out that ownership concentration can exert an impact on this moral hazard behavior of the manager through his incentives for effort. In a concentrated ownership structure, the top shareholder has strong financial incentive to control manager behavior. Concentration reduces the public good problem associated with monitoring of the manager. From the creditor's perspective, ownership concentration reduces the possibilities that managers divert resources or diminish their efforts.

[3] In his study on Chinese bank lending, Podpiera (2006) concludes that "banks do not appear to take enterprise profitability into account when making lending decisions."

[4] PriceWaterhouseCoopers (2010) estimated the market share of foreign banks in May 2010 at 2%.

[5] Other studies look at how informational disadvantage may influence the behavior of foreign investors in China. For example, Lu, Solt and Tan (2010) study the differences of behavior between foreign venture capital firms and local venture capital firms in their investment choices.