We investigate the effect of the power of creditors, property rights protection, and institutional quality, on bank profits using a panel of 498 banks from 46 countries. Results show that better institutions and stronger property rights protection reduce bank profits, while stronger power of creditors drives up bank profits significantly. Results imply that better institutions and enhanced property rights protection lead to greater flow of credit allowing firms and investors to undertake more profitable ventures. By extension, stronger creditor rights erect steeper barriers to external finance for firms and investors. National indicators of economic freedoms may be more important to lowering the spread than strict creditor rights. Seemingly, credit markets fail when economic institutions fail or when governments intervene into these markets in ways that impede the safety and soundness of financial transactions and private contracting.

This study examines how changes in countries' institutional quality affect bank profit over time. Some of the underlying factors for the observed differences in bank profit have been overlooked in the extant literature. This study investigates the effects of the following factors on bank profitability: (1) the power of creditors, or the creditors' ability to collect on legitimate claims from insolvent borrowers; (2) the property rights institutions; (3) a particular set of institutions quantifying the quality of the institutional framework, echoed in policies restricting/expanding financial and economic freedoms for firms and investors.

Investigating the relationship between bank profits and various forms of institutions has important implications for ease of access to external finance for investments and growth. There is abundant evidence on the link between finance and economic growth (Demirgüç-Kunt and Maksimovic, 1998; Beck and Levine, 2002). While Demirgüç-Kunt and Huizinga (2001) report that as the financial sector becomes larger, countries become richer; examining the persistence of bank profits, Goddard et al. (2011) find it to be negatively related to the rate of growth in GDP per capita, and positively related to bank size and entry barriers. Previously, Goddard and Wilson (2009) propose that any form of market...
failure or anti-competitive behavior on the part of banks has far-reaching implications for productive efficiency and economic growth. Claeys and Vennet (2008) highlight a negative association between GDP growth and bank net interest margin for various samples of European banks.

Banks are in the business of mobilizing and channeling finance from savers to entrepreneurs. Consequently, they are expected to generate normal profits in line with their intrinsic value, business economics, and product market, and on par with the risk levels they face. Although, lower bank profits may drive the least efficient banks out the market, long-run abnormal bank profits represent a misallocation of financial resources, which may cause investment slack, prejudicial to economic growth. Consider the case where banks consistently enjoy high long-run abnormal profits and concurrently systematic risks prevent them from lending to entrepreneurs in a manner consistent with individual borrower risk characteristics. Then this may indicate a larger institutional failure bottlenecks the economic development process, a reflection of market failure.

Evidence on how banks respond to different forms of institutions when granting credit may shape policymaking in banking. In countries with ineffective institutions, unpredictable policy swings, political instability, and a predatory state, banks operate in highly risky environments resulting in more obstacles to external finance. In such settings, banks interest margins are expected to be prohibitive, maintaining continually low levels of financial development, thin credit markets, highly profitable banking sectors, and lower economic growth. High borrowing costs and interest rate spreads impede credit expansion and investments (Chortareas et al., 2012). Vittas (1991) notes that a basic benefit of enhanced efficiency is a reduction in the spreads; a framework that is likely to stimulate greater loan demand for industrial investment (and thus contribute to higher economic growth) and greater mobilization of financial savings through the banking system.

While Demirgüç-Kunt and Huizinga (1999) link bank profit to a set of macroeconomic indicators, Laeven and Majnoni (2005) affirm that bank profits are lower in countries with an efficient judiciary. Gungoraydinoglu and Öztekin (2011) state that institutional arrangements matter for capital structure decisions. Qian and Strahan (2007) emphasize that when lending to a company in a developing economy, a bank must assess not only the credit worthiness of the borrower but also the risks due to weak laws or institutions. Theory suggests that strong and stable institutions reduce systematic risk, compelling banks to expand aggregate credit at lower spreads and longer maturity (Demirgüç-Kunt and Huizinga, 1999; Jappelli et al., 2005; Bae and Goyal, 2009), while improving their performance (Lensink and Meesters, 2014).

The role of credit information and information sharing institutions in lowering the cost of credit (Brown et al., 2009), default rates (Jappelli and Pagano, 2002), and the effects of corruption in lending practices (Barth et al., 2009) has been examined in the ongoing literature. In the law and finance and in the financial development threads of literature, for instance, La Porta et al. (1997, 1998), Djankov et al. (2007), Safavian and Sharma (2007), Acharya et al. (2011), Marcellin and Mathur (2014a,b) and Mathur and Marcellin (2014) focus on the implications of legal institutions and investor protection for the development of credit markets. Djankov et al. (2008a) assert that stronger creditor rights and more efficient debt enforcement have a direct negative impact on loan spreads. Qi et al. (2010) report that similar to, but separate from, the relation for creditor rights, greater political rights are associated with lower yield spreads. Additionally, Qian and Strahan (2007), Bae and Goyal (2009), Bennmelech and Bergman (2011) and Gungoraydinoglu and Öztekin (2011) explore the role of strong creditor rights protection in the extension of credit.

In related literature on the persistence of bank profit, using a sample of Italian banks, Agostino et al. (2005) find that abnormal profits increase with ownership concentration and decrease with competition. Similarly, Knapp et al. (2006) find that persistence of bank profits is positively related to ownership concentration for a large sample of U.S. banks. Bektas (2007) reports the same relationship looking at Turkish and Greek banks. Berger et al. (2000) confirm that impediments to competition and informational opacity continue to be strong determinants of persistence of bank profits.

There remains a significant gap in the literature on the relations between the power of creditors, property rights protection, and various aspects of institutional quality and bank profits. This study extends the law and finance literature by examining how these institutional characteristics affect the profitability of banks; and claims that these institutional indicators have differing effects on bank profits. Acemoglu and Johnson (2005) emphasize that private citizens (firms) develop informal sets of institutions to sidestep the courts when dealing with each other. Previous studies on institutions and contracts’ enforcement suggest that financial contracts are enforceable through a mix of formal and informal institutions (Fernandes and Kraay, 2007; Marcellin and Mathur, 2014a,b; Mathur and Marcellin, 2014). As a result, societal arrangements may explain to a large extent the differences in bank profits as well as financial and economic development across countries. In line with that view, the power of creditors is expected to drive up bank profits, for it provides the ground rules for lenders to enforce their claims, and in some instances, to proceed without courts’ proceedings when enforcing compliance with loan agreements. Inasmuch as a better regulatory framework coupled with an efficient judiciary guarantee stronger property rights protection and higher institutional quality, stronger property rights protection and better institutions are expected to be associated with lower spreads, and thereby lower bank profits.

To estimate the effects of institutions on bank profits, we use different data sets and levels of aggregation. We utilize bank data both at the bank and at the industry levels and analyze them in relation to various types of country level variables using fixed-effects regressions. The results indicate that improvements in institutional quality and property rights protection reduce bank profits over time, while higher power of creditors increases bank profits. Since higher bank profits suggests higher spreads and lower levels of credit flows, the results corroborate those of Cho et al. (2014) who report that strong creditor rights are associated with low long-term leverage across countries as strong creditor protection lowers long-term debt issuance, and the degree to which investments are financed with long-term debt.

The negative effect of strong property rights enforcement and enhanced institutional quality on net interest margin implies that finance follows good institutions with the possibility of a ripple effect on various economic sectors as financing increases. The positive relationship between the power of creditors and bank profits suggests that even in places where political institutions may be relatively weak, lenders have significant powers when dealing with private investors, and their rights are likely to prevail in courts. Alternatively, they may be able to circumvent the courts to settle their litigations but the resulting equilibrium between loan supply and demand remains non-optimal. Altogether, the results indicate...
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