Journal of Comparative Economics 39 (2011) 486–498

Contents lists available at ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Explaining foreign bank entrance in emerging markets

Wilhelm Althammer [a], Rainer Haselmann [b,*]

[a] HHL – Leipzig Graduate School of Management, Sparkassen-Finanzgruppe, Chair of Macroeconomics, Jahnallee 59, 04109 Leipzig, Germany
[b] Bonn University, Department of Finance, Adenauerallee 24–42, 53113 Bonn, Germany

ARTICLE INFO

Article history:
Received 28 November 2008
Revised 7 February 2011
Available online 21 March 2011

JEL classification:
G15
G21
G24
G32

Keywords:
Foreign banks
Market entrance of foreign banks
Transition economies

ABSTRACT

Althammer, Wilhelm, and Haselmann, Rainer—Explaining foreign bank entrance in emerging markets

This paper provides a theoretical framework that can explain the empirical observation that foreign banks from industrialized countries tend to increase their involvement in emerging markets in periods of market instability. In this model, domestic banks have (through past lending operations) more soft information on their borrowers available compared to foreign banks. Foreign banks, however, have a superior screening technology that allows them to obtain more hard information about their borrowers' investment projects. The model has an important implication: Foreign banks increase their market share when credit market conditions deteriorate. The rationale for this finding is that the comparative advantage of the domestic bank loses value in unstable credit market conditions. Thus, the advantage of having a screening technology becomes more important and allows the foreign bank to increase market share. In times of crisis hard information on projects is relatively more important than soft information on the borrower's history. *Journal of Comparative Economics* **39** (4) (2011) 486–498. HHL – Leipzig Graduate School of Management, Sparkassen-Finanzgruppe, Chair of Macroeconomics, Jahnallee 59, 04109 Leipzig, Germany; Bonn University, Department of Finance, Adenauerallee 24–42, 53113 Bonn, Germany.

1. Introduction

Concerns about the effects of foreign banking participation on the stability of domestic financial markets have surfaced in the recent literature. Multinational banks are able to easily relocate funds to different markets with higher expected profits through their internal capital markets. If certain regions experience instability, bankers' risk-return considerations might suddenly change, causing foreign banks to shift their activity. Foreign banks might 'cut and run' at the first hint of economic instability and therefore expedite capital flight during crisis (Morgan and Strahan, 2004).

Empirical findings are mostly not consistent with these considerations. Kroszner et al. (2007) and Dell'Ariccia et al. (2008) show that foreign banks do not mitigate the adverse consequences of local banking crises. Several papers find that foreign banks even tend to expand their credit supply during periods of economic down turns (e.g. Dages et al., 2000; Crystal et al., 2002 for a subsample of Southern American countries). Bruno and Hauswald (2009) show that foreign banks counteract the negative impact of local banking crises on growth by relaxing external financial constraints. In their analysis of foreign banks'

* Corresponding author. Fax: +49 228 73 5924.
E-mail addresses: wilhelm.althammer@hhl.de (W. Althammer), rainer.haselmann@uni-bonn.de (R. Haselmann).

0147-5967/$ - see front matter
doi:10.1016/j.jce.2011.03.002

behavior in CEE transition economies, de Haas and van Lelyveld (2004) and Kraft (2002) find that foreign banks consider problematic economic conditions as an opportunity to expand either through new acquisitions or by extending existing credit lines. Based on firm level data, Giannetti and Ongena (2010) document that foreign banks that acquire domestic banks with a high proportion of non-performing loans, appear less likely to drop their clients in contrast to domestic banks.

How can this behavior of foreign banks be explained theoretically? Why do foreign banks tend to extend and not reduce their lending in emerging markets experiencing banking crises? Why do multinational banks not reallocate their funds through internal capital markets to regions with less economic volatility? The aim of this paper is to provide a theoretical framework for such outcomes.[2] One major difference between foreign and domestic banks in emerging markets is the information set used to make lending decisions. In general, domestic banks have more soft information about their borrowers, since they have knowledge about their ability and their local environment from past lending operations. Such an information advantage of domestic banks over their foreign competitors has been widely documented in the literature (see Mian, 2006; Khanna and Palepu, 2000; Buch, 2003). In contrast, foreign banks may have better screening and/or monitoring technology available that allows them to collect hard information on their borrowers' investment projects.[3] Our model uses these differences in information structure to establish the following result: In equilibrium, foreign banks take market shares from their domestic counterparts if economic conditions deteriorate. The intuition underlying this finding is that during periods of economic instability, the availability of hard information on current investment projects becomes relatively more important than soft information on the borrower's financial history. Therefore, adverse economic conditions allow foreign banks to capitalize their technological advantage over domestic banks. Foreign banks become relatively more profitable and, thus, increase their market share.

Since no comprehensive theory of foreign banking exists, our findings add to the current literature. The model provides an explanation for the frequency of foreign market entrants, even though foreign banks have an information disadvantage and domestic economic conditions are unstable. Specifically, it also helps to explain the high market share of foreign banks in Eastern European transition countries. The paper is structured as follows. In Section 2 we derive our model and its implications. Subsequently, model implications are discussed in Section 3. Finally, conclusions are provided in Section 4.

2. Modeling foreign banks' entry into the CEE countries

The decision to enter a foreign market involves information and regulatory costs for foreign banks (Buch, 2003). Moreover, foreign banks are hindered by linguistic and cultural barriers (Chang et al., 1998). These features complicate the theoretical explanation of the high market share of foreign banks in the transition economies. Literature provides several approaches to model a bank's entry into a new market. Usually, it is assumed that banks are not perfectly informed about certain characteristics of borrowers. Dell' Ariccia et al. (1999) use a duopoly model with Bertrand competition to focus on the asymmetric information new entrants face when moving into a new market. One drawback of this type of model is an equilibrium only exists if banks pursue mixed strategies, which is difficult to interpret in practice.[4] Bouckaert and Degryse (2004) distinguish between soft information about borrowers' abilities and hard information about project outcomes. By introducing switching costs into a Bertrand competition setup, they show the existence of an equilibrium in pure strategies, and illustrate how banks may strategically disclose information about borrowers to new market entrants. Contrary to these duopoly models, Lehner and Schnitzer (2008) use a Hotelling model of spatial competition to analyze the spillover effect on domestic banks after the entry of a foreign banks with a superior screening technology. Detragiache et al. (2008) analyze the effect on a competitive equilibrium if a foreign bank enters that has lower costs to monitor hard information, but higher costs to monitor soft information. By assuming switching costs, the model derived in this section is building on the basic structure of Bouckaert and Degryse (2006). We extend their framework by assuming that the entrant bank has access to a screening technology, which allows her to evaluate investment projects of credit applicants with a noisy signal. Thus, the incumbent bank has a competitive advantage concerning soft information and the entrant bank has an advantage concerning hard information.

2.1. Background and setup

In the subsequent, we consider credit markets in emerging markets. There are two periods and two representative banks, a domestic bank I (also referred to as the incumbent bank) and a foreign bank E (also referred to as the new entrant bank). In $t = 1$, the domestic bank has a monopoly and gives out credits to borrowers. Bank I has no initial information on the borrowers' characteristics. The situation in $t = 1$ is assumed to be exogenously given and is, therefore, not further modeled. Nevertheless, it is necessary that bank I makes a positive profit. By being the monopoly bank in the market during the first period, the domestic bank establishes a relationship with its borrowers as done in the model of Rajan (1992). This relationship allows bank I to observe characteristics of the borrower. In the second period $t = 2$, the market is opened to new entrants so that the foreign bank can decide to enter the market and compete with the domestic bank. Competition throughout the sub-

[2] The focus of this paper is on foreign banks' reaction to crises in emerging markets. The transmission of financial instability originating from developed markets through foreign banks (i.e. the financial crisis of the year 2008) is not the focus of this paper. See Cetorelli and Goldberg (2010) on this issue.

[3] These assumptions match the circumstances in many emerging markets (see e.g. Sengupta, 2007; Claeys and Hainz, 2006).

[4] Some approaches that attempt to explain the high foreign market share in the transition economies (e.g. Hainz, 2003; Claeys and Hainz, 2006) are based on this model structure.