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The impact of foreign bank entry in emerging markets: Evidence from India

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ABSTRACT

This paper uses the entry of foreign banks into India during the 1990s—analyzing variation in both the timing of the new foreign banks' entries and in their location—to estimate the effect of foreign bank entry on domestic credit access and firm performance. In contrast to the belief that foreign bank entry should improve credit access for all firms, the estimates indicate that foreign banks financed only a small set of very profitable firms upon entry, and that on average, firms were 8 percentage points less likely to have a loan after a foreign bank entry because of a systematic drop in domestic bank loans. Similar estimates are obtained using the location of pre-existing foreign firms as an instrument for foreign bank locations. Moreover, the observed decline in loans is greater among smaller firms, firms with fewer tangible assets, and firms affiliated with business groups. The drop in credit also appears to adversely affect the performance of smaller firms with greater dependence on external financing. Overall, this evidence is consistent with the exacerbation of information asymmetries upon foreign bank entry.

1. Introduction

In many less-developed countries (LDCs), inefficient domestic banks and a lack of competition among lenders result in high borrowing costs and limited financial access for many firms. More developed countries, such as the US, Japan, and those in the European community, argue that LDCs should allow foreign banks to enter into their economies.[1] By increasing competition, foreign bank entry may

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[1] In a memo to the World Trade Organization on June 6, 2005, delegations from Japan, the US, and EU argued that "Policies that impede competition, such as entry restrictions and restrictions on foreign banks, have been shown to raise the cost of financial services and hurt economic performance". WTO Document #05-2335.

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increase the supply of credit and improve efficiency.[2] However, banking theories that incorporate information asymmetries demonstrate that greater competition among banks may actually reduce some firms' access to credit (Petersen and Rajan, 1995). Moreover, the high cost of acquiring information about local firms may limit foreign banks to 'cream-skimming', where they lend only to the most profitable local firms (Dell'Ariccia and Marquez, 2004; Sengupta, 2007) and adversely affect both domestic banks and the firms that rely upon them (Detragiache et al., 2008; Gormley, 2007).

These competing theories naturally lead to this paper's central questions: does foreign bank entry improve credit access for domestic firms, and if so, which firms? Moreover, do these changes in the credit market affect the performance of domestic firms? The growing trend among LDCs to allow greater foreign bank entry and the degree of entry that typically occurs suggests that the answers may have important implications for financial policy in these economies. To answer these questions, this paper uses the entry of foreign banks into India during the 1990s to estimate the effect of foreign bank entry on domestic credit access. Geographical variation in foreign bank locations across India over time and the availability of firm-level loan data facilitates the use of novel identification techniques and makes India an ideal setting to analyze the impact of foreign bank entry. Using this data, I find evidence both of 'cream-skimming' by foreign banks and of a systematic drop in loans from domestic banks following foreign bank entry that lowers overall credit access for many domestic firms, particularly smaller firms, firms with fewer tangible assets, and firms affiliated with business groups. The drop in credit also appears to adversely affect the performance of smaller firms with greater dependence on external financing. Overall, this evidence is consistent with banking theories that incorporate information asymmetries and has numerous policy implications.

To identify the effect of foreign bank entry, I match financial data for Indian firms with the geographical location of newly-established foreign bank branches following India's 1994 commitment to the World Trade Organization (WTO) to allow greater foreign bank entry. Foreign bank entry was staggered: some districts received a foreign bank branch as early as 1994, while others did not receive such a branch until 2001, and as of today, many districts have yet to receive a foreign bank. I then compare changes in the borrowing patterns of domestic firms located geographically near the new banks to changes in the borrowing patterns of firms located further from the new banks. This use of variation *both* in the timing of the new foreign banks' entries *and* in their location within the country reduces potential biases that might arise from other country-wide changes to market openness, banking sector regulation, or access to public debt markets. Such country-wide changes would affect all firms in India and therefore unlikely explain changes in borrowing trends over time for firms located geographically near foreign banks versus those that are not. Moreover, by using firm-level data, I can also test for changes in credit access across different types of firms as well as control for any differences in the types of firms located in areas with a new foreign bank.

To account for the endogenously-determined location choice of the new foreign banks within India, I also use the geographical distribution of foreign firms in India before the WTO agreement as an instrument for the location choice of new foreign banks following the agreement. I assume that foreign banks chose to enter markets with firms from their home country in order to preserve pre-existing relationships with these firms, but that these foreign firms' presence is not otherwise related to domestic lending trends at the local level. This tendency for foreign banks to follow their customers abroad has been noted in a number of countries (Sabi, 1988; Brealey and Kaplanis, 1996) and seems to occur in India as well. Moreover, there is no evidence that a foreign firm's presence in India was otherwise related to the lending patterns of domestic firms located geographically nearby. Further buttressing the empirical design employed in this paper is the fact that numerous tests indicate that the necessary identification assumptions hold, and the instrumental variable (IV) estimates are similar in sign and magnitude to the ordinary least squares (OLS) estimates.

Overall, the estimates suggest that competition from foreign banks is associated with a reallocation of loans that is not necessarily a boon to the lion's share of domestic firms. The most profitable 10% of

[2] Characteristics unique to foreign banks may also directly increase credit access in LDCs. Foreign banks may be less susceptible to politically-connected loans (Agenor, 2003); domestic banks may benefit directly by adopting the technologies of foreign banks (Lensink and Hermes, 2004); and foreign banks may be more efficient, have access to international capital markets, and encourage the development of better auditing agencies (Levine, 1996).