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Foreign entry and bank competition ☆

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Abstract

Foreign entry and bank competition are modeled as the interaction between asymmetrically informed principals: The entrant uses collateral as a screening device to contest the incumbent's informational advantage. Both better information ex ante and stronger legal protection ex post are shown to facilitate the entry of low-cost outside competitors into credit markets. The entrant's success in gaining borrowers of higher quality by offering cheaper loans increases with its efficiency (cost) advantage. This paper accounts for evidence suggesting that foreign banks tend to lend more to large firms thereby neglecting small and medium enterprises. The results also explain why this observed bias is stronger in emerging markets.
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1. Introduction

Traditional theories of financial intermediation assert that information asymmetries are central to bank lending. Prospective borrowers typically know more about their ability to repay loans than lenders do. Accordingly, banks screen borrowers to select high-quality entrepreneurs and reduce risk of default among low-quality ones. A more recent literature on relationship lending takes the view that repeated interactions can reduce such information asymmetries between bank and borrower (see references in Boot, 2000). According to this view, banks gain knowledge about payoff-relevant borrower attributes during the course of a lending relationship. Consequently, relationships emerge as a prime source of an incumbent bank's comparative advantage over potential outside lenders. This undermines competition in credit markets; the incumbent's superior information about its own clients weakens a competitor's ability to offer credit at lower interest rates.

The purpose of this paper is to understand how this problem affects foreign entry and lending behavior in credit markets.[1] Banks are modeled as asymmetrically informed principals: The incumbent has complete information about borrower credit-risk, but the entrant does not.[2] This relies on the notion that much of the information regarding a borrower's unobservable risk can be obtained only in the process of lending (Boot and Thakor, 1994, 2000). This paper studies competition between an entrant bank (uninformed lender) that faces observationally identical borrowers, who can be one of two types (high-risk or low-risk), and an incumbent (informed lender) that can distinguish between these borrower types.

In addition, banks could require the borrower to secure loans with collateral. Both theoretical and empirical findings have shown that collateral requirements fall over the duration of the bank-borrower relationship (Boot and Thakor, 1994; Petersen and Rajan, 1994; Berger and Udell, 1995; Harhoff and Körting, 1998). This contrast between secured lending for new borrowers and unsecured lending for established ones is suggestive of the information content in collateral requirements (Sharpe, 1990; Boot and Thakor, 1994). Relevant to the discussion here is the implication that this role of secured credit assumes greater importance for an entrant seeking to create new relationships than for an incumbent lending to its established clients. Accordingly, this paper uses a screening model, based on Besanko and Thakor (1987b, hereafter B-T), to examine the entrant's use of collateral as a screening device to contest the incumbent's informational advantage.

The results indicate that both ex ante better information and ex post stronger legal protection can facilitate the entry of low-cost outside competitors into credit markets. Market segments characterized by a greater proportion of high-risk borrowers frustrate

[1]The intention here (and in the title of the paper) is to use the term "foreign" in the broad sense of the word. As Morgan and Strahan (2004, p. 241) observe: "In the United States, banks from other states were long viewed as foreign, and most states strictly forbade entry by banks from other states until the mid-1970s. Even banks from other cities *within* a state were often blocked from opening branches in other cities in the state. Loosely speaking, the hometown bank was local, and banks from anywhere else were foreign."

[2]At the outset, it is important to emphasize that borrower risk here refers to the unobservable component in credit risk, as opposed to observable risk, that is readily evaluated from company financial statements and credit reports. Also, this paper considers de novo foreign entry in terms of outside banks setting up a branch or a subsidiary in a new location. The analysis presented here abstracts from alternative modes of entry such as mergers and acquisitions and from situations that describe the complementarities between informed (bank) capital and uninformed capital (Morgan and Strahan, 2004).

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