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The Third Pillar of the Basel Accord: Evidence of borrower discipline in the Kyrgyz banking system

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ABSTRACT

We empirically study the asset side of market discipline in the banking system of the Kyrgyz Republic, examining whether borrowers are willing to pay higher interest rates to high-quality banks. Based on dynamic panel models and a dataset with bank information from 23 banks over the period 2010–2012, our findings suggest the presence of market discipline induced by borrowers. In other words, banks with higher capital ratios and liquidity charge higher interest rates on loans. This result has several implications for the banking policy in Kyrgyzstan, where we can recommend to policymakers a disclosure policy following the Third Pillar of Basel III, because not only can the bank's creditors use bank information to penalize the excessive bank risk, but borrowers can also use this information to discipline their banks.

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1. Motivation

Kyrgyzstan is one of the poorest post-Soviet countries, but its commercial banks have been developing rapidly in the last decade, increasing banking competition, yet with several problems of stability (National Bank of the Kyrgyz Republic, 2013a). In 2010, jointly with the global financial crisis, several bank failures provoked significant losses for the Kyrgyz economy. Evidently, the transition to a market economy is a complicated task.

In early April 2010, anti-government political demonstrations occurred in various cities of the Kyrgyz Republic. These protests turned into riots, resulting in loss of life and material damage (Asian Development Bank et al., 2010). The global economic crisis as well as the domestic political crisis significantly reduced the banking solvency. The uncertainty and insecurity associated with these crises led people to increase their cash holdings, negatively impacting banking deposits, and credit to the private sector (National Bank of the Kyrgyz Republic, 2011, 2013a, 2013b).

The National Bank of the Kyrgyz Republic (NBKR)[1] made attempts to rescue the banking sector, but the failure of one of the largest banks, Asia Universal Bank (AUB), was inevitable, causing a domino effect. Actually, AUB was audited because of suspicious transactions, principally, offenses related to money laundering and corruption. As a result, other three banks (Investbank Issyk-Kul, Manas Bank, and Kyrgyz Credit Bank) were put under temporary closing-down.

In this context, the Soviet past and little experience in the market economy give Kyrgyz banks a particular relevance to study the transition to international standards of

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[1] This is the official name of the Central Bank. Under perestroika, the monobank system was replaced with a two-tier banking system. In February 1992, the state bank (Gosbank USSR) was renamed the National Bank of the Kyrgyz Republic (NBKR), with responsibilities for safeguarding the payments system, providing liquidity, licensing and supervising second-tier banks (Brown et al., 2009; Ruziev & Majidov, 2013).

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accounting, reporting, and regulation (Ruziev & Majidov, 2013), where, since 1988, the Basel Committee has played the most important role in banking policy. In 2004, Basel II introduced three basic pillars: (1) Minimum capital requirements, (2) Supervisory review process, and (3) Market discipline (Basel Committee on Banking Supervision, 2006).

The objective of market discipline is to complement the first and second pillars of banking regulation and supervision. Moreover, the new approach in Basel III situates the relevance of market discipline on the same level as governmental supervision, and its main function is to facilitate market punishment for excessive risk. Consequently, the Basel Committee proposes disclosure and transparency policies to equip market participants with all needed information for decision-making, and to combat suspicious financial transactions, money laundering, and the financing of terrorism.

In economic terms, market discipline weakens asymmetric information and moral hazard concerns. It can be understood as the behavior of market participants, and can be easily analyzed using the supply and demand model. For instance, in the deposit market, depositors will respond to riskier behavior of their banks demanding higher interest rates on deposits (price mechanism of market discipline) or/and withdrawing their deposits (quantity mechanism of market discipline). As a result, the banks should moderate their risk-taking (Tovar-García, 2014). Other bank creditors should analogously react to bank risk, mainly subordinated debt holders, because they are the last in line to recover their financial assets in case of bankruptcy (Evanoff, Jagtiani, & Nakata, 2011; Tovar-García, 2015b). The interbank market has been grown considerably during the last three decades, and there is also evidence for peer monitoring, where lending banks monitor and charge higher rates to low-quality banks (Distinguin, Kouassi, & Tarazi, 2013; Tovar-García, 2015a).

The market discipline effect induced by depositors, subordinated debt holders, and other banks has already been widely examined. This hypothesis has been tested in China (Wu & Bowe, 2012), in ex-socialist countries including Estonia, Latvia, and Lithuania (Hasan, Jackowicz, Kowalewski, & Kozłowski, 2013), several times in Russia (Karas, Pyle, & Schoors, 2010, 2013; Peresetsky, 2008; Semenova, 2007; Tovar-García, 2013; Ungan, Caner, & Özyıldırım, 2008), but it has not been tested in ex-Soviet Asian countries.

Conversely, there is comparatively little attention paid to the asset side of market discipline. There are theoretical and empirical findings suggesting that borrowers also punish their banks because of excessive risk-taking. In a theoretical model, Allen, Carletti, and Marquez (2011, p. 984) state that "when credit markets are competitive, market discipline coming from the asset side induces banks to hold positive levels of capital as a way to commit to monitor and attract borrowers". Thus, banks have incentives to achieve high levels of capital, and in many cases bank capital ratios are higher than the minimal requirement suggested by the Basel Accord.

In the case of Norway, Kim, Kristiansen, and Vale (2005, p. 682) point out that "banks face market discipline induced by borrowers", because they are willing to pay higher rates on loans from high-quality banks for two major reasons: First, they have a certification motive, where borrowers prefer banks with high-quality loan portfolios to signal their creditworthiness to other stakeholders. Second, borrowers have a refinancing motive, where they choose solvent banks because these banks are able to extend credit lines or new loans in the future. Similarly, in the Mexican case, Tovar-García (2012) found evidence in favor of the certification and refinancing motives, but the largest Mexican banks can avoid this kind of market discipline. In Russia, the interest rates on loans discriminates between high- and low-quality banks, where high-quality banks charge higher interest rates in accordance with the market discipline hypothesis from the asset side (Tovar-García, 2013).

Thus, the Basel Committee proposes market discipline as a key instrument to strengthen the stability and effectiveness of the banking sector. However, in several developing countries the evidence in favor of the market discipline hypothesis is weak, and the stability of the banking system is often the responsibility of monetary authorities, with problems of corruption, lack of experience, and lack of technology (Calomiris, 1999; Tovar-García, 2014). In the case of ex-Soviet countries, arguably, market discipline should not fundamentally work because of deficient markets (Matovnikov, 2012). Consequently, the Kyrgyz Republic is timidly following the recommendations of Basel III, including the disclosure policy to support market discipline (Barth, Caprio, & Levine, 2013).

Given this, the objective of this research is to test the existence of market discipline from the asset side in the Kyrgyz banking system and to analyze its implications for banking policy. Accordingly, this research is focused on the following question: In Kyrgyzstan, do borrowers pay higher interest rates to high-quality banks? Based on previous studies, we hypothesize that Kyrgyz borrowers pay higher interest rates on loans to high-quality banks (low-risk banks) because they prefer solvent banks with high capital ratios and low loan losses; that is, borrowers have a refinancing motive (to ensure future credit lines and new loans) and a certification motive (to signal their creditworthiness to other stakeholders).

We test these hypotheses using a sample of 23 commercial banks of the Kyrgyz Republic and quarterly data from January 2010 to December 2012. Based on dynamic panel models, our findings suggest the presence of market discipline induced by borrowers. This has several implications for banking policy in Kyrgyzstan, where we can recommend a disclosure policy following the Third Pillar of Basel III. The rest of the paper proceeds as follows. Section 2 describes the Kyrgyz banking system, and the data used in this study. Section 3 outlines the empirical strategy and presents the results. Section 4 concludes.

2. The Kyrgyz banking system

In the 1990s and in the beginning of the 2000s, several reforms supported the establishment of a two-tier banking sector, foreign bank entry, financial liberalization, and privatization, intended to increase the size, stability, and efficiency of the Kyrgyz banking sector. The result was a reduction in interest rates on loans and deposits (to support economic

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