



How should we bank with foreigners? An empirical assessment of lending behavior of international banks to six East Asian economies

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ABSTRACT

We construct macro-and micro-panel data on international bank lending to six Asian economies—Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand—over the period 2000 to 2010 to analyze a number of objectives. The paper first examines the critical determinants not only to overall international bank lending but also to cross-border bank lending, and find that cross-border lending by international banks tend to pull out from host economies during difficult times in source economies, whereas such retrenchments are not evident on the basis of overall lending. The paper next examines the differences between subsidiaries and branches of international banks in their ability to shield themselves from the financial difficulties of their global parent banks and thus their ability to continue lending in destination markets. The results show that foreign bank subsidiaries are more capable in this regard.

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1. Introduction

Lending by foreign banks, be it cross-border loans or loans extended by these banks' foreign affiliates, has been an important component of the expansion of capital flows in developed and emerging economies alike in recent years. The total claims on developing countries held by international banks reporting to the Bank for International Settlements (BIS), stood at \$3.1 trillion in the third quarter of 2007, a year before the collapse of Lehman Brothers.¹ Sixty-percent of this exposure was extended mostly to residents of countries in Latin America, East Asia, and Europe and Central Asia (World Bank, 2008). According to earlier evidence, one benefit of such a marked expansion in lending by international banks is that it can smooth liquidity shocks in the context of crisis originating from economies that are recipient of these flows (e.g., de Haas & van Lelyveld, 2006, 2010; Peria, Powell, & Vladkova-Hollar, 2005).

However, the interruption to the spectacular rise in lending by international banks during the 2008–2009 economic crises serves as a reminder that international banks can play a central role in transmitting crises emanating from major developed countries, the sources of these flows, to recipient countries. As Cetorelli and Goldberg (2011) note, while reversals occurred in “all broad categories of inflows, the sharpest decline was by far in international bank loans”. Explaining the stability in lending by

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¹ The amount was almost six times larger than in 1992, when international banks were recovering from the Latin American debt crisis of the early 1980s.

international banks should therefore be important in understanding how crises spread from advanced to emerging markets. In this regard, one of the pertinent questions we ask in this paper is whether an escalation in international bank exposure translates into stable lending on the part of these international banks in the face of economic disturbance in their own economies.

In dealing with this pertinent question, one novelty of this paper is that it adopts an integrated or top-down approach by first assessing the lending behavior of international banks at the aggregate or macroeconomic level by utilizing country-level international banking data. Specifically, we compare the extent of influence of a set of variables on overall international bank lending as opposed to cross-border lending by international banks. In doing so, we are able to investigate the distinctive contribution of the same set of variables on the two channels by which international banks lend—cross-border lending as compared with local lending. Next, the paper turns to analyze the determinants of the growth in local lending by the individual affiliates of these international banks. In contrast, the strand of post 2008–2009 crisis literature on the drivers of stability in lending by international banks has emphasized either the aggregate or macroeconomic story only (e.g., [Buch, Carstensen, & Schertler, 2010](#); [Cetorelli & Goldberg, 2011](#); [Herrmann & Mihaljek, 2010](#); [McGuire & Tarashev, 2008](#)), or solely considered the micro aspects by using individual bank-level data (e.g., [de Haas & van Horen, 2012, 2013](#); [Popov & Udell, 2012](#); [Schnabl, 2012](#)).

In view of our use of bank-level loan data, one other novelty of this paper is that we analyze foreign bank behavior distinguishing between branches and subsidiaries. Specifically, our study goes further by dealing with the contentious policy issue of the mode or organizational form of entry of international banks. We ask the pertinent question on whether subsidiaries and branches of international banks have a crisis-mitigating impact in terms of an unfettered capacity to lend, particularly during the 2008–2009 global financial crises. More to the point, we want to know whether there is a significant difference between these two organizational forms of entry as far as their ability to withstand financial difficulties in their global parent banks and thereby are able to continue lending in the host economies.

This is a crucial research question that has recently been brought into the limelight of policy discussions. One argument, for instance, is that the attraction of being able to easily protect the assets of subsidiaries of foreign banks as opposed to foreign bank branches leads banking regulators to favor an organizational bank structure comprising mainly subsidiaries rather than branches ([Fiechter et al., 2011](#); [Mihaljek, 2010](#)). In addition, as a perceived advantage for the international bank, the ability to screen and monitor its lending activities may be improved by the establishment of a local subsidiary ([de Haas & van Horen, 2013](#)). On the other hand, [Aghion and Tirole \(1997\)](#) argue that the establishment of subsidiaries could potentially create “functional distance” with the parent bank as information may not be efficiently passed on from the subsidiary to the bank’s headquarters.

Finally, this paper also adds to studies on international financial contagion. Some authors have analyzed whether international financial linkages amplify the transmission of crisis across countries (e.g., [Bekaert, Harvey, & Ng, 2005](#); [Goldberg, 2002](#); [Guo, Chen, & Huang, 2011](#); [Haile & Pozo, 2008](#)), while other studies examine whether certain types of capital flows are more prone to sudden reversals around the time of crisis (e.g., [Hutchison & Noy, 2006](#); [Neumann, Penl, & Tanku, 2009](#); [Reinhart & Rogoff, 2009](#); [Siregar & Choy, 2010](#)). Our results complement this research on international financial contagion by examining periods in which cross-border bank lending and local lending by foreign banks are especially volatile.

The paper proceeds as follows. [Section 2](#) provides a brief survey of the related literature. [Section 3](#) presents key trends and stylized facts on international banking flows to five Southeast Asian economies (Indonesia, Malaysia, Philippines, Singapore, Thailand) and the Republic of Korea. As will be shown in the discussion, these six economies are known for their reliance on international bank lending, both prior to the 1997–98 Asian financial crisis as well as in the years preceding the 2008–2009 global financial crisis. [Sections 4 and 5](#) explain the empirical approach and the data employed, respectively. [Section 6](#) discusses our empirical findings. [Section 7](#) concludes.

2. Brief literature review

Prior to the 2008–2009 global financial crisis, a strand of literature found that international banks have a stabilizing effect on aggregate lending during times of host country financial turmoil. [Peria et al. \(2005\)](#) confirm such a stabilizing role in the case of foreign banks claims on the Latin American private sector, [de Haas and van Lelyveld \(2006\)](#) in the case of Eastern Europe, and [de Haas and van Lelyveld \(2010\)](#) for a broader set of countries.

Subsequently, the global financial crisis of 2008–2009 triggered a flurry of research that examine on how international banks transmit shocks coming from home economy or developed country financial markets to other countries. Some have used bilateral country-level data, while other studies have employed bank-level data to show how international banks transmit a home-country shock across borders. Example of studies with regard to the former include [McGuire and Tarashev \(2008\)](#) which show that cross-border lending declined more in the case of banking sectors with high average expected default rates. [Cetorelli and Goldberg \(2011\)](#) find that banking sectors that depended more on short-term US dollar funding experienced a greater decline in cross-border lending; [Buch et al. \(2010\)](#) claim that the growth rate of world energy prices has a significant effect on banks’ foreign assets. Meanwhile, [Herrmann and Mihaljek \(2010\)](#) show that greater global risk aversion and expected financial market volatility have the greatest impact on the curtailment of cross-border bank lending during the crisis of 2007–2008.

Whereas, examples of studies that employ bank-level data include [Popov and Udell \(2012\)](#) that show how less capitalized western European banks reduced the credit supply of their eastern European subsidiaries. [de Haas and van Horen \(2012\)](#) presented evidence that bank-specific funding shocks contributed to the curtailment of cross-border credit after the demise of Lehman Brothers, and shocked banks restricted their credit more to small borrowers. Similarly, [Schnabl \(2012\)](#) show how international banks transmitted the shock of the 1998 Russian default by reducing their cross-border lending to banks active in Peru.

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