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Bank ownership structure, lending corruption and the regulatory environment[☆]

Thierno Amadou Barry[a], Laetitia Lepetit[a,*], Frank Strobel[b]

[a] *Université de Limoges, LAPE, Limoges, France*
[b] *University of Birmingham, Department of Economics, Birmingham, UK*

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We empirically examine whether bank lending corruption is influenced by the ownership structure of banks, a country's regulatory environment and its level of economic development. We find that corruption in lending is higher when state-owned banks or family-owned banks provide a higher proportion of credit to the economy, in both developed and developing countries. A stronger regulatory environment, either through a stronger supervisory regime or a higher quality of external audits, helps to curtail bank lending corruption if induced by family-controlled ownership, but not if induced by state-controlled ownership. We further find that controlled-ownership of banks by other banks contributes to reduce corruption in lending; the same applies to widely-held ownership of banks, but only for developed countries. *Journal of Comparative Economics* **000** () (2015) 1–20. Université de Limoges, LAPE, Limoges, France;University of Birmingham, Department of Economics, Birmingham, UK.

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1. Introduction

Well-functioning banking systems can channel savings to the most productive investment projects, thereby assuring efficient capital allocation and enhancing economic development and growth (see e.g. Levine, 1997; 2005). A potential friction that could endanger the efficiency of this capital allocation mechanism is corruption arising in the lending process. Corruption in financial intermediaries hinders the efficient allocation of capital to smaller firms, forcing them to abandon profitable investment opportunities and thereby reducing firm growth (Beck et al., 2005), while firms with bank connections may have easier access to funding than firms without such ties (Charumilind et al., 2006; Laeven, 2001). Loans offered to related parties (shareholders of the bank, their associates and the firms they control) can have higher default rates and lower recovery rates than unrelated ones (La Porta et al., 2003). Given the negative effects of lending corruption on the efficient allocation of capital, firm growth and bank soundness, it is important to determine the causes of lending corruption in order to help policymakers better understand how to reduce it. Our study refines and builds on the existing literature examining these issues, with a particular focus on the role of ownership characteristics, the regulatory environment and the degree of economic development of the countries concerned.

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* Corresponding author.
E-mail addresses: thierno.barry@unilim.fr (T.A. Barry), laetitia.lepetit@unilim.fr (L. Lepetit), f.strobel@bham.ac.uk (F. Strobel).

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Several papers look into the country-level factors that might influence the occurrence of corruption in banks' lending decisions, using a firm-level database drawn from the World Business Environment Survey (World Bank, 2000). Beck et al. (2006) examine the impact of different supervisory policies on lending corruption and find that powerful supervisory agencies reduce integrity in bank lending, whereas greater private monitoring of banks decreases lending corruption. Barth et al. (2009) extend that study and find that greater competition in banking and information sharing via credit bureaus/registries contribute to reducing lending corruption. Building on these two studies, Houston et al. (2011) find that state ownership of media accentuates bank lending corruption as it decreases the likelihood of corruption being detected and punished.[1] A complementary literature, using loan-level data for particular countries, highlights that banks are more prone to lending corruption when the controlling owner is the state: government ownership of banks facilitates the financing of politically desirable projects that maximize the private welfare of politicians instead of maximizing social welfare (see e.g. Dinç, 2005; Khwaja and Mian, 2005; La Porta et al., 2002; Sapienza, 2004). In line with this political capture view, Houston et al. (2011) find that government ownership of banks induces more lending corruption, whereas Beck et al. (2006) do not observe a significant relationship between the two; both introduce simple control variables reflecting the prevalence of state owned banks in national banking systems. Barth et al. (2009) control for private bank ownership instead, arguing that it can help reduce lending corruption by shaping managerial incentives; they find only weak support for greater private bank ownership lowering lending corruption.

Our paper complements this literature by exploring further the linkages between bank corporate governance and lending corruption. To examine these issues in more detail, we consider a finer classification of bank ownership type than in previous studies, by differentiating banking systems according to the amount of credit provided by banks that are widely held or that are controlled by a single owner. As incentives to extract private benefits of control, such as those related to lending corruption, can vary across different types of controlling owners, we investigate if the degree of lending corruption depends on whether the prevalent controlling bank ownership type in an economy is either the state, a family, an industrial company, a bank or an institutional investor. Shareholders who are themselves owned by multiple owners have lower incentives to extract private benefits as these will be diluted among their multiple owners (Villalonga and Amit, 2006); this is more likely to be the case for banks, industrial firms and mutual and pension funds. On the other hand, the incentives for private benefit extraction are stronger when the controlling owner is a family or the state, since those are better able to effectively divert benefits to themselves (Claessens et al., 2002; Villalonga and Amit, 2006). Moreover, banks controlled by owners with multiple business connections with non-financial firms might be more readily inclined to engage in lending corruption (Charumilind et al., 2006; La Porta et al., 2003; Laeven, 2001); this might be the case for governments, but also for families, industrial companies and banks.

Where controlling owners have incentives to engage in lending corruption and thereby influence credit allocations, it becomes of interest to determine if governance by external stakeholders, in particular regulators, can curb such behavior. For this, we examine if the level of monitoring and control imposed by external audits and supervisory actions can constrain any opportunistic corrupt behavior in the lending process associated with controlling owners. We also take the investigation further by examining if the level of economic development of a country has an impact on the relationship between controlling ownership and bank lending corruption. Resources available to combat corruption are more abundant in developed countries (Rose-Ackerman, 1999); however, there are also more transactions and therefore greater opportunities for corruption in these countries compared to developing ones (Laffont, 2006).

In order to study the role of ownership structure on bank lending corruption in greater detail, we examine a sample of 4693 firms across 51 countries, using survey data from the World Business Environment Survey (World Bank, 2000) to measure bank lending corruption. We find evidence that the ownership structure of banks has a significant influence on corruption in lending. On one hand, our results show that firms located in countries where state-owned banks provide a higher proportion of loans to the economy face higher lending corruption, both in developing and developed countries with a substantial level of corruption of public official. We additionally find that family-controlled ownership contributes to increased lending corruption in both developed and developing countries. Banks, when controlled by industrial companies, also contribute to increased lending corruption, but only in developed countries. On the other hand, when banks are controlled by other banks, lending corruption is reduced. We further find that banks with a dispersed ownership structure help to decrease corruption in lending, but only in developed countries. Our results also show that a strong supervisory regime or a high quality of external audits help to curb bank lending corruption induced by family-controlled ownership, but do not reduce lending corruption when banks are controlled by the state or an industrial company.

We thus contribute to the literature examining the causes of bank lending corruption in several ways. First, we investigate whether the corporate governance of banks influences lending corruption by analyzing if controlling ownership is associated with higher levels of bank corruption, and if this relationship depends on the type of the controlling shareholder. By examining the two dimensions of ownership concentration and ownership type, we aim to obtain a better understanding of the underlying mechanisms at work, to promote better ways of combating and deterring lending corruption. Second, we examine whether the regulatory environment, through the strength of supervisors and the quality of external audits, can have an impact on the likelihood of corrupt behavior being detected, and thereby lower the incentives of a bank's controlling shareholder to engage in bank lending corruption. Lastly, we explore whether banks having controlled ownership has a greater influence on lending corruption in developing countries than in developed countries.

[1] More recently, Zheng et al. (2013) find evidence that firms domiciled in "collectivist" countries are more affected by lending corruption than firms in "individualist" countries.

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