Journal of Comparative Economics 42 (2014) 160–177

Contents lists available at SciVerse ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Modes of foreign bank entry and effects on lending rates: Theory and evidence

Sophie Claeys [a,b], Christa Hainz [c,d,*]

[a] Ghent University, W. Wilsonplein 5D, 9000 Ghent, Belgium
[b] Sveriges Riksbank, Research Department, 103 37, Stockholm, Sweden
[c] Ifo Institute and CESifo, Poschingerstr. 5, 81679 München, Germany
[d] Institute for East and Southeast European Studies, Landshuter Str. 4, 93047 Regensburg, Germany

A R T I C L E I N F O

Article history:
Received 18 June 2009
Revised 20 December 2012
Available online 8 February 2013

JEL classification:
G21
D4
L31

Keywords:
Banking
Foreign entry
Mode of entry
Interest rate
Asymmetric information

A B S T R A C T

Claeys, Sophie, and Hainz, Christa—Modes of foreign bank entry and effects on lending rates: Theory and evidence

Policy makers who decide to liberalize foreign bank entry frequently put limitations on the mode of entry. We study how different entry modes affect the lending rates of foreign and domestic banks. In our model, the mode of entry determines whether a foreign bank inherits a customer base. This, in turn, affects how information is distributed between foreign and domestic banks. We show that this distribution of information about incumbent customers leads to stronger competition if foreign entry occurs through a greenfield investment. As a result, domestic bank lending rates are lower after greenfield entry. We find empirical support for this prediction for a sample of banks from 10 Eastern European countries for the period 1995–2003. *Journal of Comparative Economics* **42** (1) (2014) 160–177. Ghent University, W. Wilsonplein 5D, 9000 Ghent, Belgium; Sveriges Riksbank, Research Department, 103 37, Stockholm, Sweden; Ifo Institute and CESifo, Poschingerstr. 5, 81679 München, Germany; Institute for East and Southeast European Studies, Landshuter Str. 4, 93047 Regensburg, Germany.
© 2013 Association for Comparative Economic Studies Published by Elsevier Inc. All rights reserved.

1. Introduction

In many emerging markets, foreign banks own the majority of banking market assets. However, foreign market entry has triggered a big debate both in politics and the academic literature. Policy makers are concerned about the cherry picking strategies of foreign banks, but appreciate the capital and know-how that they bring into the country. In the academic literature, the findings about the impact of foreign bank entry on the host country are contradictory. Some papers argue that financial intermediation decreases after foreign bank entry (Detragiache et al., 2006), while others point out that access to credit improves (Giannetti and Ongena, 2008). These authors do not distinguish between foreign banks that entered by means of a greenfield investment and those that did so by acquiring a domestic bank. But to what extent does the impact of foreign bank entry depend on the mode of entry? Is competition more intense and are lending rates lower if a bank enters through a greenfield investment rather than through an acquisition?

* Corresponding author. Address: Ifo Institute for Economic Research, Poschingerstr. 5, 81679 Munich, Germany. Fax: +49 89 92241462.
E-mail address: hainz@ifo.de (C. Hainz).

0147-5967/$ - see front matter © 2013 Association for Comparative Economic Studies Published by Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.jce.2013.01.009

To study these questions, we analyze the impact on the banking market of the host country of greenfield investment versus entry through acquisition. One obvious effect of greenfield investment is that it increases the number of competing banks. This implies that competition becomes more intense (see, for instance, Lehner and Schnitzer, 2008). The mode of entry also affects the distribution of information between banks. We study how the asymmetric distribution of information between banks determines the degree of bank competition.

We use a model in which one domestic bank and one foreign bank engage in Bertrand competition. The crucial difference between foreign and domestic banks lies in their ability to acquire information about (potential) debtors. Domestic banks gain information about their old customers during a previous business relationship. They thus possess an incumbency advantage. Neither the domestic bank nor the foreign bank have information about firms that newly enter the credit market. However, compared to the domestic bank the foreign bank has a better screening technology for evaluating the creditworthiness of new applicants. Thus, the foreign bank possesses a screening advantage.

Most importantly for our analysis, the mode of entry determines whether the foreign bank inherits a customer base and thus, how information about these firms is distributed between the domestic and the foreign bank. Thereby it also determines the composition of the bank's portfolio. In the case of greenfield entry, the foreign bank does not have a customer base and therefore does not possess information about old firms. The foreign bank has a screening advantage with respect to the new applicants while the domestic bank has an incumbency advantage with respect to the old firms. In the case of foreign entry via acquisition, the foreign bank acquires a customer base and all the information related to it. Thus, the foreign bank has both a screening advantage with respect to new applicants and an incumbency advantage with respect to the firms in its customer base. The domestic bank still has an incumbency advantage, but only with respect to the firms in its own customer base. Accordingly, the crucial difference between the entry modes is the degree to which the domestic bank possesses an incumbency advantage.

As a result, information on the inherited customer base is distributed asymmetrically between banks. This asymmetry in the information on the inherited customer base determines the degree of bank competition. The less information a bank possesses, the more likely it is to grant loans to bad firms and this is costly because the bank must write off the loans. Our setup is similar to a Bertrand model in which firms have different costs. In our model, the foreign bank always has an information advantage (and thereby also a cost advantage); otherwise it would not enter. The foreign bank's advantage is higher in the case of acquisition than in the case of greenfield investment. This implies that the relative position of the domestic bank in terms of information is weaker in the case where the foreign bank enters through acquisition. Therefore, when the foreign bank enters through acquisition, the domestic bank needs a higher interest rate to cover the higher costs resulting from this information disadvantage. This also allows the foreign bank to demand a higher interest rate. Consequently, competition is less intense and therefore the lending rates of both the domestic and the foreign banks are higher if entry takes place through an acquisition rather than a greenfield investment. Thus, the mode of entry has a differential competition effect when banks compete for new applicants.

The impact of this differential competition effect on bank lending rates depends on each bank's portfolio composition. The portfolio of banks which inherit a customer base consists of new and old firms. The repayment of old firms depends on their bargaining power. Good old firms without a track record in equilibrium pay the same lending rate as new applicants. Thus, the competition effect applies to them as well. However, for good old firms with a track record, competition is perfect and they pay less than new applicants. Thus, the composition of the portfolio of new firms and good old firms without a track record on the one hand, and good old firms with a track record on the other hand, determines the average lending rate a bank demands. We refer to this effect as the portfolio composition effect.

We test the model using a sample of banks from 10 Eastern European countries for the period 1995–2003. For these banks, we can derive average lending rates. Based on the theoretical model we have two main predictions about the effect of the mode of entry on the average lending rates in the periods after entry. First, due to the competition effect, domestic banks charge relatively lower interest rates following greenfield entry than in the case of entry via acquisition. Second, provided that the share of firms with a track record is low, foreign greenfield banks charge, on average, lower interest rates than foreign acquired banks. We find evidence supporting the competition effect.

This paper is related to both theoretical and empirical studies of foreign bank entry. Theoretical studies have highlighted the problems of asymmetric information in lending between new entrants and incumbent banks. They show that the resulting adverse selection problem establishes a barrier to market entry (Dell'Ariccia et al., 1999). However, market entry takes place if the entrant can collateralize (Sengupta, 2007) or if it has lower refinancing costs (Dell'Arricia and Marquez, 2004).[1] The foreign bank may also possess a comparative advantage in processing hard information, which may result in cream-skimming and ultimately leads to a lower degree of financial intermediation (Detragiache et al., 2006).[2]

Our paper is most closely related to van Tassel and Vishwasrao, 2007, who study which mode of entry a foreign bank chooses if it has lower refinancing costs. They show that foreign banks prefer acquisition over greenfield entry because they acquire information about the existing customer base. Unlike van Tassel and Vishwasrao, 2007, we take the mode of entry as given and analyze the impact of the entry mode on the credit market. Furthermore, we assume that all banks have identical refinancing costs, but that foreign banks differ from domestic banks because they are better able to screen applicants. Thus,

[1] We discuss the predictions that can be derived from the Dell'Arricia and Marquez, 2004 paper in the empirical analysis in Section 3.

[2] A similar result is obtained by Gormley, 2006b who assumes that foreign banks have access to cheaper funds, but also have higher screening costs. Gormley, 2006a suggests that foreign bank entry may reduce financial intermediation in India.

Download English Version:

https://daneshyari.com/en/article/5092384

Download Persian Version:

https://daneshyari.com/article/5092384

Daneshyari.com