Foreign Banks in Poor Countries: Theory and Evidence

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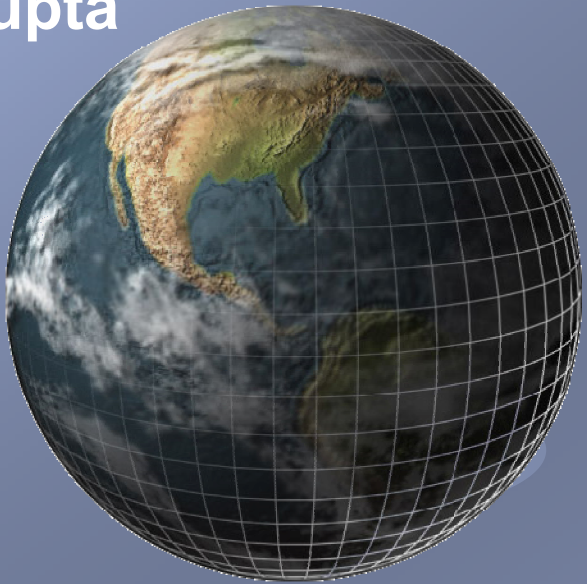

Comments by
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Findings and General Comments

- Shows in theoretical model that foreign bank entry can lead to cream-skimming, undermining ability of local banks to engage profitably in soft information/relationships lending
- Empirical evidence that private credit is lower/grows less in countries with more foreign presence/entry

- Important issue for many developing countries; standard analytical model; usual data, number of robustness tests

- But surprising results!
  - Could some omitted factors, in particular concurrent financial reforms, be causing relationships?
  - Might foreign banks be more prudent and lower credit wisely, even for overall financial system?
  - There will be other tradeoffs as well, not captured

Questions on the model

- Standard screening model, with pooling/non-pooling combinations leading to variations in access for different classes of borrowers
- Applied to various problems (education, insurance), also in domestic financial intermediation contexts (more competition, greater distance, more hard information, etc)
- Consider other dimensions that show some of the tradeoffs:
  - Foreign banks may affect relationship lending. Even with same technology, foreign bank (entry) can lead to more competition, with two effects: lower profit can lower access for information-intensive firms; or less hold-up problems can increase access
  - Technology choices endogenous and affect competition & access
  - Mentioned: foreign banks may also have better risk management, allowing them to lend more to risky borrowers, opposite effects

Empirical Framework

- Empirical setup
  - Cross-section analysis suffers from many endogeneity issues (e.g., foreign banks go to low credit countries). Controlling for endogeneity is key
  - Paper does a good job of running all robustness tests: a panel with fixed effects, GMM, and IV; also look at the (growth) in credit
- Findings do contrast, however, with current thinking:
  - Literature finds foreign bank presence in emerging countries increases access to loans, especially for large and transparent firms. But: SMEs (more soft-information) are not worse off and large foreign banks do equal as local banks (Mian 2006, Giannetti and Ongena 2005, Clarke, Cull and Martinez Peria 2001)
  - What explains differences in results? Are other stories, in spite of robustness, possible?

Other stories and empirics

- Likely other financial reforms, besides opening up and financial crises, when foreign bank entry increased
  – These could have negatively affected financial depth, e.g., led to more prudent banking, cleaned up non-performing loans, etc.
  – In Mexico, for example, lending was surely affected by better regulation and supervision following crisis and large entry
- Foreign banks may make local banks:
  – More prudent, leading to less lending in short-run; and
  – More transparent leading to higher loan-loss provisioning and reserves, but not because local banks do riskier lending
- Variables used do not control for all of this, as they do not all have time variation or do not cover specifically banking system regulation and supervision

Some questions on empirics

- The time span is short, five years on average, yet much happened in terms of entry, financial crises, reforms, etc.
- The panel regressions include fewer controls, e.g., not financial crises; what happens if more controls are included?
- Effects are found in developing countries only, not in developed countries. Consistent with story, but suggests some omitted aspects. Also, why are transition economies different?
- The access (ATM/Branches) are cross-sectional data, remain just indicative. Also use loan/deposit size/population
- Data show financial presence is especially pronounced in SSA and more limited in Central and Eastern Europe: odd
- Outliers, for example, figure 5, crises, financial reform?
- On page 16, you downplay the value of loan-loss provisioning data due to accounting differences, yet later use such data

Empirical Extensions/Complements

- Make result more robust and include possible tradeoffs
- Like to see the effects of foreign banks on local banks separate from own actions of foreign banks
  - E.g., foreign bank takes over local bank, cleans it up, lowers credit (growth), but what do domestic banks do?
  - Suggest a specification which is different from linear?
- Investigate individual banks, foreign and domestic
  - In the credit extension to different type of borrowers: here evidence from borrowers suggest different results
  - Effects of foreign banks on quality of lending (not just loan-loss provisioning, but also profitability, efficiency etc) of local banks
  - Look at effects of bank size (irrespective of ownership): larger, more hard-information?
  - Data are available (already use some)

Empirical Extensions

- Study the entry/exit decisions of individual banks
  - It has been found that: “banks are more likely to get acquired in a cross-border deal if they are large, bad performers, when the host economy is growing and when the bank sector is concentrated. Post-acquisition performance for the target bank does not improve in the first two years. These results are caused by a decrease in net interest margins and an increase in overhead costs.”
  - Ricardo Correa, Cross-border Bank M&As: Is there a Performance Effect?
- This suggest not only endogenous entry, but also slow effects on the target bank (and possibly on credit)?
- Suggest to look at host bank type, including origin
  - Bank origin matters in the entry choices, controlling for other factors

Empirical Extensions

- Differentiate mode of entry, greenfield versus acquisition, in information-intensive lending
  – It has been found that: “different entry modes affect the interest rate for loans in a model in which domestic banks possess private information about their incumbent clients but foreign banks have better screening skills. Our model predicts that competition is stronger if market entry occurs through a greenfield investment and therefore domestic banks' interest rates are lower. We find empirical support for our results for a sample of banks from 10 transition countries of Eastern Europe for the period 1995-2003.”
  – Sophie Claeys and Christa Hainz “Acquisition versus greenfield: The impact of the mode of foreign bank entry on information and bank lending rates”
- Suggest entry modes impact credit differently

Policy Issues and Implications

- The paper can expand on implications
  - What is overall value of foreign banks, taking into account other aspects: competition, stability, political economy, etc?
  - Lending is going towards hard information everywhere, especially in more developed countries, the home of many foreign banks
    - Do we see this as good/bad?
    - Is there an alternative whatsoever, and how dependent is this on country circumstances?
  - If the origin of foreign banks matters, can there be a balanced entry strategy?
    - Some hard banks from developed countries, some soft banks from developing countries?