The Real Effect of Foreign Banks

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“The end of cross-border banking in emerging markets?”

Motivation

• Foreign-bank entry is very controversial: they are catalysts for financial and economic development…
  – entrants supply new loanable funds, expertise, consolidation
  …but are feared to displace the local banking sector
  – local banks retrench: net effect on access to credit unclear
• Theoretical and prior empirical work is inconclusive
  – information and its distribution is crucial for predictions
• Investigate the consequences of foreign-bank entry
  – taking into account the competitive reaction of local banks
  – identify the economic channels through which entry affects local firm performance and real economic activity
Preview of Results

- Net of local banks’ response, foreign lenders alleviate
  - external financing constraints on firm performance
  - informational and debt-contracting problems
- Foreign banks offset effects of local banking crises
  - mitigate an extreme form of a credit crunch and stabilize local economic activity by lessening firms’ financial dependence
- Entry unambiguously stimulates real economic activity
  - mode of entry matters: only acquisitions giving access to local lending expertise relax external financing constraints
  - foreign banks substitute for local credit-market infrastructure
- Findings are robust to local institutional development

Empirical Predictions

- Foreign banks increase supply of loanable funds
  - facilitate access to credit translating into faster firm growth
- Foreign banks cherry-pick the best credit risks
  - as the quality of local borrower pool falls domestic banks cut back lending: access to credit and firm growth fall
- Mode of entry matters: greenfield vs. acquisition
  - access to local borrower information as a barrier to entry
- Systematic variation: emerging vs. advanced countries
  - where are external financing constraints more stringent?
  - effects should systematically vary across country type
Data Description

- World-Bank database on foreign banks: financial and ownership data on institutions in 106 countries
- UNIDO Statistics: value added by 36 industries
  - unbalanced country-industry panel from 1995 to 2003
- 22 advanced and 59 developing countries: 9,738+ obs.
  - growth: real-value added by country-manufacturing industry
  - foreign-owned banking assets as a fraction of domestic ones
  - host of economic, financial, and institutional controls
- Financing needs of US firms as benchmark: Compustat

Empirical Strategy

- Growth and the presence of foreign banks are more likely than not jointly endogenous
  - countries with better growth prospects due to financial, economic or institutional development attract (more) entry
- Difference-in-difference estimation by simple OLS
  - focus on manufacturing industries: -0.4% mean growth
  - compare effect across time (industry’s real Growth) across countries in terms of foreign-bank penetration (ForBkAS)
  - effect of foreign banks on growth of financially dependent industries net of competitive reaction of local lenders
- Financial-dependence benchmark FinDep: industry median of externally funded CapEx of US firms
The Presence of Foreign Banks

• Foreign banks have an independent beneficial effect on firm performance net of the domestic reaction
  – by relaxing external financing constraints (by specification)
• Industry in the 75th percentile of FinDep in a country in the 75th percentile of ForBkAS grows
  – 1.17 percentage points faster than those located at the corresponding 25th percentiles on average (full sample)
  – 2.12 percentage points faster growth in developing countries
• Foreign banks do not displace local ones: Assets/GDP
  – but foreign banks 7 times more important: effect on the margin
• Simultaneity bias? entry even benefits worst performers

Foreign Presence and Banking Crises

• If foreign banks relax external financing constraints their presence is most beneficial in credit crunches
  – local banking crises: Crisis = 1 in years of crisis as tabulated in IMF study by Laeven and Valencia (2008), 0 else
  – replicate FinDep·Crisis results in the literature for our data
• Foreign banks neutralize crisis effects on real growth
  – curious Africa effect: given dysfunctional banking systems … foreign banks act as additional destabilizing elements
• Policy lesson: foreign banks counteract credit crunches
  – in case of minimal institutional and financial development
Entry Mode

• Affects foreign entrant’s access to information
  – acquisition: access to local lending expertise and borrowers
  – greenfield: local affiliates rely on parents’ lending technology

• Only entry through M&A affects firm performance
  – economic and statistic significance: no greenfield effect

• Information production by foreign banks represents a second channel they affect real economic activity by
  – M&A effect only significant for emerging countries: benefit most from entrants’ superior credit-assessment expertise
  – absence of the usual trappings of modern credit markets

Credit-Market Infrastructure

• Lending presupposes institutional infrastructure
  – ex ante: credit bureaus for (raw) information and its sharing
  – ex post: creditor rights, contract enforcement, legal recourse
  – measures from doingbusiness surveys: Djankov et al. (3x+)

• Foreign banks as substitutes for lending infrastructure
  – developing nations: institutional development insignificant
  – advanced economies: institutional development matters

• Exception, but small economic effect: creditor rights
• Policy lesson: invest in institutional infrastructure
Conclusion

• Foreign banks further real economic activity by
  – lessening the effects of financial dependence on firm growth
  – overcoming informational obstacles to granting credit
  – substituting for legal development and contract enforcement

• The positive impact is net of local competitive reaction
  – foreign banks stabilize growth prospects in banking crises

• Policy lessons: emerging vs. developing economies
  1. invest in credit-market infrastructure: property rights, contract enforcement, information gathering and sharing
  2. foreign entry relaxes financial constraints at the margin (in local crises): new funds but no displacement of local lending