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THE EFFECT OF FOREIGN BANK ENTRY ON THE COST OF CREDIT IN TRANSITION ECONOMIES. WHICH BORROWERS BENEFIT THE MOST?

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NON-TECHNICAL SUMMARY

In the last two decades we have witnessed a high penetration of foreign banks into financial markets of transition and developing economies of Eastern Europe, Latin America, and Asia. The most dramatic change took place in Central and Eastern European countries (CEECs), where more than 70 percent of banking assets are now in the hands of foreign investors. This phenomenon has led to a heated debate about costs and benefits of foreign bank ownership. The existing empirical evidence shows that lending rates of foreign banks are lower than those of domestic institutions (Martinez Peria and Mody (2004) Claeys and Hainz (2007)). However, this empirical finding can be interpreted in two different ways. First of all, lower lending rates of foreign institutions can be explained by their superior performance due to higher cost-efficiency, better risk management and cheaper cost of funds due to access to international capital markets ("performance" hypothesis). Alternativley, this can be explained by "portfolio composition" hypothesis. Dell'Ariccia and Marquez (2004) argue that foreign banks have advantages in targeting more transparent new clients, whereas domestic banks are better placed to lend to opaque firms based on soft information. Taking into account that lending rates in market segments for more transparent clients are lower due to higher competitiveness of these segments, the lower lending rates of foreign banks could be related to their specific portfolio composition tilted towards large corporations. The portfolio composition effect can additionally manifest itself in other dimensions of the loan contract such as the maturity and currency structure of loans.

To our knowledge there has been no attempt to distinguish between "performance" and "portfolio composition" hypotheses for lending rates of banks with different ownership structure and mode of entry. The reason for this lies in the lack of data on the composition of banks' loan portfolios. In this study we aim to fill this gap by using a unique database of detailed information on Polish banks, provided by the National Bank of Poland.

Our results provide support to the hypothesis that foreign banks, particularly greenfield ones, are more willing to extend loans to transparent borrowers (e.g. large private firms). At the same time domestic private banks specialize in loans to non-transparent borrowers, such as small entrepreneurs. We also find that foreign banks, particularly greenfield ones, are more prone to extend loans in foreign currency, even though the share of these loans has been declining recently.

Our findings support the "portfolio composition" hypothesis, and thus contradict studies that argue that greenfield banks charge lower lending rates than private domestic banks due to their superior performance. Moreover, earlier studies argue that there is a convergence of interest rates between banks of different types of ownership. We show that this effect is also due to portfolio composition, as the share of transparent borrowers has fallen from 80 percent of loan portfolio of greenfield banks in 1996 to around 56 percent ten years later.

Our results have important policy implications. We show that lifting barriers to foreign bank entry is not associated with significantly reduced lending rates for borrowers, neither transparent nor opaque ones. In order to reduce lending rates, other reforms should be implemented that ensure low inflation, increase competition on the market, etc. In order to reduce cost of credit for small entrepreneurs, reforms should focus on establishment of credit registries for small entrepreneurs, clarification of laws that cover the seizure of collateral in case of borrower's delinquency and reform of the court system which is still very costly and time-consuming.

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