Comparative Advantage of Domestic vs Foreign Banks in SME Lending

Author: Thorsten Beck, Professor of Economics. Tilburg University

SME Lending Techniques

The traditional view of SME finance focuses on relationship lending. Longstanding relationships between a financial institution, or even a specific loan officer, and the borrower allow problems of information asymmetry and thus risk to be overcome. While costly, given the lack of audited financial statements and the scarcity of collateralizable assets, relationship lending, based primarily on "soft" information gathered by the loan officer through continuous, personalized, direct contacts with SMEs, their owners and managers, and the local community in which they operate (see Berger and Udell, 1996), has long been seen as the only effective way of lending to SMEs.

Beyond being a critical decision on the level of financial institutions, the question of what lending techniques are best in serving SMEs has broader repercussions for financial sector policy, as it is directly related to market and ownership structure of banking systems. The conventional wisdom regarding SME finance is that small and domestic banks are more likely to finance SMEs because they are better suited to engage in relationship lending. Under this paradigm, large and foreign-owned banks are less likely to be able to cater to SMEs as internal hierarchies are less conducive to processing soft information.

Recently the more nuanced view has been put forward that large and foreign banks can have a comparative advantage at financing SMEs through arms-length lending technologies (e.g., asset-based lending, factoring, leasing, fixed-asset lending, credit scoring, etc.) and centralized organizational structures instead of relationship lending (see Berger and Udell, 2006 and de la Torre, Martinez Peria and Schmukler, 2008). This would imply that foreign banks can lend to SMEs to the same extent as domestic banks, but using different techniques and structures. Increasingly, there is also empirical evidence that supports this new paradigm. In the following, I will present two studies supporting this, one based on bank-survey data and the other based on loan-level data from a credit registry.

Bank-level survey evidence

In 2006, we sent out a survey to the largest five banks in 80 countries, with 56 questions on three areas: (1) documenting banks' perceptions regarding the SME segment, (2) understanding banks' business models (in particular, lending technologies and organizational structures) used to serve SME, and (3) quantifying the extent, type, and pricing of bank financing to SMEs. In total, we obtained responses from 91 banks in 45 countries. Our sample includes 17 government-owned banks, 32 domestic private banks and 42 foreign-owned banks. One of the issues we can address with this survey is to assess the extent and conditions at which banks in different countries and of different ownership types lend to SMEs and the different lending techniques and organizational structures they use. The results are reported in Beck, Demirguc-Kunt and Martinez-Peria (2011).

Our main findings can be summarized as follows:

- There are significant differences across ownership types in lending technologies and organizational structures. Foreign banks are more likely to use hard information relative to private domestic banks. The share of SME loans that is secured is higher among foreign than domestic banks. Compared to domestic banks, foreign banks tend to be least likely to decentralize loan decision making and risk management. Consistent with theory, these results thus confirm that foreign banks do indeed use different lending techniques and organizational structures to reach out to SMEs

- Controlling for ownership and country type, there are few significant associations between lending techniques and organizational structure, on the one hand, and the extent, type, and pricing of SME loans, on the other hand. This suggests that different lending techniques and organizational structures are associated with similar outcomes in terms of SME lending.
- There are few significant differences in the extent, type, and pricing of SME lending across bank ownership types. Most notably, we find no evidence that foreign banks tend to lend less to SMEs than other banks. This is consistent with the first two sets of results: foreign banks lend to SMEs as much, but using different lending techniques and organizational structures.
- There are significant differences between developed and developing countries; the share of SME lending for investment purposes is significantly lower in developing countries, while fees and interest rates are higher. These differences in SME financing between banks in developed and developing countries seem to be explained by differences in the economic, legal, and institutional environment banks operate in. These differences are stronger than any differences across banks of different ownership.

In summary, bank-level survey data suggest that both relationship and transaction-based lending is appropriate for SMEs and that both domestic and foreign-owned banks can cater to this important firm segment. However, this study leaves open the question whether banks of different ownership adjust their lending techniques to different clienteles (among the large SME population) or whether differences in lending techniques are independent of the clientele. In the following, I will address this question.

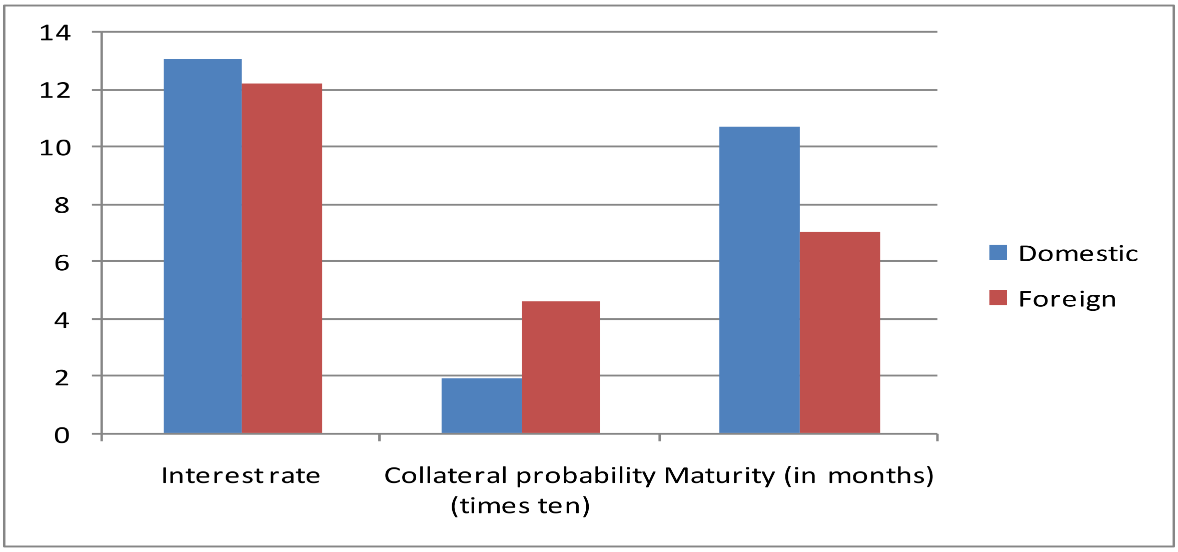
Loan-level evidence

In another paper (Beck, Ioannidou, and Schäfer, 2012), we use loan-level data from the Bolivian credit registry for the period between January 1998 and December 2003. For each loan, we have information on the origination and maturity dates, contract terms, and ex post performance. For each borrower, we have information about their industry, physical location, legal structure, bank lending relationships, and whether they have been delinquent or defaulted on any loan. We focus on commercial loans denominated in US dollars from one of the 13 commercial banks that were active in Bolivia during this period. All in all, this yields 32,279 loans to 2,672 firms.

In order to understand whether differences in contract terms between domestic and foreign bank loans are solely due to their different clienteles or also due to the use of different lending technologies, we hold the clientele constant and compare the contract terms of domestic and foreign bank loans to the *same firm* in the *same month*. To this end, we restrict our analysis to a sub-sample of loans to firms that receive a new loan from at least one foreign and one domestic bank in the same month. The restriction results in a sub-sample of 5,137 loans to 287 firms.

Exploring variation in loan contract terms for a sample of firms that borrow from both domestic and foreign banks in the same month, and as illustrated in Figure 1 we find that:

- Foreign banks charge loan interest rates that are on average between 89 and 107 basis points lower than the interest rates of domestic banks, which constitutes a 9% discount relative to the interest rate of domestic bank loans in the sample.
- Foreign bank loans are, on average, 27 percentage points more likely to have collateral - a large effect given that only 33% of all loan contracts in our sample include collateral - and have maturities that are up to 33% shorter than domestic bank loans, which, at the average maturity of nine months, implies a difference of two to three months.
- Domestic banks base their loan pricing on the length of their relationship with the borrower, especially in the case of smaller firms, while foreign banks have a more transaction-based pricing approach, relying on borrower ratings and collateral, especially for larger firms.



In summary, domestic and foreign-owned banks cater to the same clientele but using different techniques. For borrowers, there is a trade-off, with lower interest rates on foreign bank loans, but longer maturity and less need for collateral on domestic bank loans.

Conclusions

Evidence from bank- and loan-level data is consistent in that both foreign and domestic banks can cater to SMEs and that both relationship and transaction-based lending can be used for lending to small enterprises. These findings have important repercussions for the debate on banking structure (i.e. large vs. small banks) and the debate on cross-border banking, as they show that one size does not fit all. However, they also show that the effectiveness of foreign bank lending to SMEs depends on the existence of sound contractual frameworks and credit registries, consistent with cross-country findings by Claessens and van Horen (2013).

These findings also point to further questions. Do banks change their lending techniques over time, as they grow or with time after entry into a new country? Are there differences in the effectiveness of different lending techniques over the business cycle? And are there differences in the effectiveness of different lending techniques across different sub-groups of small and medium-sized firms?

References

Beck, Thorsten, Aslı Demirgüç-Kunt, and Maria Soledad Martinez Peria. 2011. Banking Financing for SMEs: Evidence Across Countries and Bank Ownership Types, *Journal of Financial Services Research* 39, 35-54.

Beck, Thorsten, Vasso Ioannidou and Larissa Schäfer. 2012. Foreigners vs. Natives: Bank Lending Technologies and Loan Pricing. CentER and ECB Discussion Paper, forthcoming.

Berger, A. N. and Udell, G. F., 1996. Universal Banking and the Future of Small Business Lending. In: Saunders, A., Walter I., (Eds.), *Financial System Design: The Case for Universal Banking*. Irwin (Richard D), Burr Ridge, IL, 559-627.

Berger, Allen N., and Gregory F. Udell, 2006, A More Complete Conceptual Framework for SME Finance, *Journal of Banking & Finance* 30, 2945-2966.

Claessens, Stijn and Neeltje van Horen. 2013. Foreign Banks: Trends and Impact. *Journal of Money, Credit and Banking*, forthcoming.

De la Torre, Augusto, Maria Soledad Martinez Peria, and Sergio Schmukler, 2010. Bank Involvement with SMEs: Beyond Relationship Lending. *Journal of Banking and Finance* 34, 2280-93.