



# Analysis of Foreign Bank Operation- Comparison of Creditor Rights and Information Sharing

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**Abstract:** The continued operation of foreign banks is of great concern. This article compares and analyzes the two major influencing factors of foreign bank operations- creditor rights and credit information sharing. In addition, this article also discusses whether we should pay more attention to creditor rights or credit information sharing, taking consideration of the advantageous lending technology (SME credit scoring model) of foreign banks.

**Keywords:** Foreign bank; Creditor rights; Information sharing

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## 1 Creditor rights

Larger creditor rights can increase the profitability of banks. This is because creditor's rights can prevent adverse selection and moral hazard between borrowers and lenders, thereby reducing the information asymmetry problems caused by them (Kalyvas and Mamatzakis, 2017; Marthur and Marcelin, 2015). In the case of unfamiliar borrowers, banks often need to screen the quality of borrowers when issuing loans to avoid financing borrowers who are rejected by competitors, and collateral can be used as a means to classify their projects. (Jiménez and Saurina, 2004). Berger et al. (2011) also elaborated on this view. They also pointed out that collateral plays a big role in debt contracts, because collateral not only reflects the quality of the borrower beforehand, but also demonstrates moral hazard afterwards. In addition, Jiménez et al. (2006) stated that in a strong

debt environment, it is more obvious that banks use collateral to screen the quality of borrowers, because high-quality borrowers are relatively low-quality borrowers. That said, the possibility of using collateral is greater. This means that when borrower information is not disclosed, those borrowers who believe that their credit quality is high will use high levels of collateral to prove their credit quality in order to ensure lower loan interest rates, but their credit level. Relatively low borrowers will not do this behavior.

More creditor rights can also conducive to the reduction of the borrower's moral hazard, thereby increasing the bank's performance. La Porta et al. (1998) explained that debt gives the creditor the ability to recover when the borrower (company) fails to pay as promised. The right to collateral. As the rights of creditors increase, the supply of credit will increase. Since corporate borrowers are less willing to take risks, if the demand for borrowing is not affected, the overall leverage ratio will increase. Due to the low default rate of loans, the performance of banks will increase as leverage increases (Kalyvas and Mamatzakis, 2017).

However, the increase in the rights of creditors may in turn affect the performance of banks. This is because the rights of creditors are correlated with the increase in loans (DMS, 2007). The increase in debt will increase the expected recovery rate. In this case, banks will be more willing to provide credit loans to customers regardless of the borrower's credit level. This will increase the probability of default by the borrower, and at the same time, if banks have an investment portfolio, their default rates will increase. Under this circumstance, if the bank's expectation of

borrowers' recovery is lower than the bank's expected default rate, the bank's operating risk will increase and its performance will decline (Houston et al., 2010).

In addition, as the rights of creditors increase, the use of collateral also increases, which may increase the moral hazard of lenders and reduce the profitability of banks. Manove and Padilla (1999) explained that collateral will reduce the screening work of banks in the process of issuing loans. At the same time, Manove et al. (2001) also showed in their research that, in the sense of reducing social surplus, when banks are competitive in the context of information asymmetry, the use of collateral in the loan issuance process will reduce the motivation of banks to screen borrowers, so that a large number of worthless projects are invested. Excessive reliance on collateral will decrease borrowers' quality. The use of collateral also increases the ex post probability of loan default (Cowan et al., 2015). Although the use of collateral will effectively increase the bank's credit to SMEs, in this case, borrowers with insurance loans are more likely to be in arrears during the repayment period than uninsured loans. This effect is particularly obvious among larger borrowers, and this situation will significantly affect bank performance.

## 2 Credit information sharing

If the level of information sharing increases, banks can accurately assess the quality of individual borrowers in a lower cost and more direct way, thereby improving bank performance (Kalyvas and Mamatzakis, 2017). This is because through the sharing of loan information, the lender can reduce the risk of adverse selection based on the knowledge of the borrower's past behavior, screen high-credit borrowers, and improve the effectiveness of the loan. Kallberg and Udell (2003) pointed out that information sharing can enhance the due diligence process at the initiation stage, thereby helping to reduce the probability of adverse selection problems, increase the number of high-quality borrowers, and reduce loan interest rates and default rates. Dierkes et al. (2013) also found that credit information sharing can greatly improve the quality of default prediction, and the higher the value of the credit information provided by the company, the lower the loan default rate, which is conducive to the growth of bank

performance.

The improvement of the level of credit information sharing can also reduce the moral hazard of borrowers, thereby improving bank's yield. Padilla and Pagano said in 2000 that creditors often share customer information, which not only helps banks to understand the credit and risk status of the borrower more quickly, but also serves as a disciplinary measure to restrain the borrower. This is because the information sharing between banks makes the borrower have to perform better in order to obtain a good credit rating from other lenders, avoid being blacklisted and to maintain contact with lending in the future. Doblas-Madrid and Minetti (2013) studied the impact of the level of bank information sharing on the performance of borrowers in the credit market, and found that it does not reduce the use of collateral, but has a binding effect on borrowers' contract defaults and defaults. As a result, the loan default rate becomes lower. More information sharing among lenders can improve the bank's loan portfolio, enhance the bank's ability to respond to financial crises, reduce the bank's bankruptcy risk, and benefit the growth of profit. (Houston et al., 2010)

However, credit information sharing may degrade bank performance. Stiglitz and Weiss (1981) explained that information sharing is very important for loans. If the bank has more knowledge about the borrower's credit history or other information, the lender does not need to worry too much about the financing of risky projects when making loans. The credit line will be expanded, which may increase the bank's understanding of low quality. The borrower's supply of credit leads to an increase in the overall risk of default. In addition, Dell'Ariceia and Marquez (2006) also proved this theory after studying the relationship between the information structure of the loan market and bank loan decisions. They pointed out that as the sharing of information between banks and borrowers increases, banks may relax their lending standards, leading to an increase in overall credit lines, a deterioration in investment portfolios, and a decline in bank performance and greater operational risks.

Moreover, an increase in the level of credit information sharing will in turn increase the moral hazard of borrowers, which is not conducive to the growth of bank performance. Mailath and Samuelson (2001) studied a market with two types of companies,

namely "incompetent" companies and "competent" companies. Competent companies tend to buy average rather than extreme reputations in the market, while incompetent companies often build a low reputation by sharing positive historical information, offset the influence of bad credit events, and make themselves more profitable. In addition, Cheng and Degryse (2010) found that although information sharing can improve banks' understanding of the quality of borrowers, when borrowers give additional positive information, negative information tends to be weakened. In other words, the lender will not pay too much attention to the borrower's default information, which will increase the borrower's moral hazard. Borrowers emphasize more new positive information, weaken unfavorable factors, and more low-quality companies will be offered loans, which is not conducive to the growth of bank performance.

### **3 Which factor is more important for foreign banks**

The SME credit scoring model is a trading technology that focuses on the more formal information of the SME owners and companies being evaluated, such as the financial indicators and performance reports of the companies. It has an important influence on the credit acquisition of creditworthy SMEs. In addition, for foreign banks, credit scoring models can help them reduce their information disadvantages relative to local competitors (Berger and Udell, 2006). The use of credit scoring models can also allow banks to "harden" various soft information and pass them to high-level organizations, and aggregate hard and soft information into credit scores, thereby reducing the negative impact of the distance between banks and borrowers (Beck et al., 2018).

Creditor rights are more important for foreign banks that use SME credit scoring models. In terms of creditor rights, Haselmann et al. (2010) believe that for foreign banks, domestic banks have more information and cultural advantages than foreign banks. If the protection of the rights of formal creditors is strengthened, these obstacles will be reduced, and foreign banks can give full play to their professional knowledge and technology. In addition, Kalyvas Mamatzakis, (2017) also pointed out that the use of collateral for banks is very useful, because if foreign banks have a disadvantage in the grasp

of borrower information compared with domestic competitors, the use of collateral can be reduced. This asymmetric factor is conducive to the growth of foreign banks' performance. What is more, Yin et al. (2020) stated that although SMEs create a lot of social wealth and employment opportunities, it is very difficult for them to obtain funds in the credit market. Banks are more willing to lend loans to large companies with higher levels of profit and security. The main reason is that there are many information asymmetries between SMEs and the credit market, such as incomplete information systems and financial systems. The information between the records is asymmetric. However, Beck et al. (2018) showed that the contractual feature of collateral can be used to alleviate the problem of asymmetry of information before and after the credit market. They researched a sample of companies borrowing from the same bank in different geographical locations, and found that in the process of issuing loans, using collateral and credit scoring models can overcome the information disadvantages of foreign banks. In addition, if collateral is used as a binding tool for loan default, the default rate of bank loans will be lower and loan returns will increase. Therefore, in summary, due to the emphasis on the participation of collateral, creditor rights are more worthy of attention than credit information sharing.

### **4 Conclusion**

In the article, I first discussed the beneficial and adverse effects of creditor rights and credit information sharing on bank performance. Then, based on the SME credit scoring model, the foreign bank's advantageous lending technology, I pointed out that the rights of creditors should be taken Pay more attention. The shortcoming of this article is that since the predecessors did not have much research on the selection of foreign bank addresses and information asymmetry, more research is needed to support these views in the future.

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