Non-performing Loans and Branch Deregulation

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Abstract

The paper attempts to theoretically and empirically explain why banks provide loans to firms to induce overinvestments. In an oligopoly market with strict restrictions in which regulation is temporally relaxed, a bank is likely to increase its branches, as well as employees, even if it cannot make a short-term profit. The reason for this is that the loss of profit by non-performing loans (npl) is regarded as an entry cost. Branch restrictions were relaxed for local (commercial and city) banks in China in the period 2009–2014, whereas the "big four" banks operated without restrictions. Therefore, this deregulation can be considered as a quasi-natural experiment on the potential impacts on bank behavior and performance. Using over one million observations of bank branches, geographic competition index by city is measured. Analysis of macro- and micro-panel bank data (>890 observations from 2007–2017) showed that branch deregulation policy significantly increased the bank competition, decreased quality of offerings and profits, while significantly increasing the number of branches, employees, and npl.

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Highlights

1 This paper discusses why banks provide loans to firms to induce overinvestments under branch deregulation.

2 When regulation is temporarily relaxed in a restricted market, a bank's rush to increase its branches and employees, even if it cannot make a profit, and the loss incurred by non-performing loans (npl), are regarded as entry costs.

3 The deregulation of local branches of banks in China from 2009–2014 can be considered as a quasi-natural experiment on the potential impacts on bank behavior and performance.

4 Using over one million observations of bank branches, geographic competition index by city is measured.

5 Based on macro- and micro-panel bank data and DID method, the branch deregulation policy significantly increased geographic competition, reduced the quality of bank offerings and profits, whereas the number of branches and employees, as well as npl, increased significantly.