

DIW Berlin

German Institute
for Economic Research



The Role of Lacking Ownership Transparency for the Stability of the Banking Sector

Patricia Alvarez-Plata

I) Lacking ownership transparency and solvency of single banks

Two main problems:

- a) Opacity in ownership undermines efforts to assess and control **connected-party** transaction
- b) Opacity in ownership facilitates **asset stripping**

a) Connected lending :

- Connected lending: extension of bank loans to parties, somehow connected with the bank
- Allows insiders to divert resources from investors to themselves
- If a substantial percentage of the banks' loans to such activities
→ Particular concern to the regulator
- Risks are primarily: **lack of objectivity in credit assessment**
undue concentration of credit risk

The Risk of lacking objectivity in credit assessment

- Credits extended on conditions and in volumes more favorable than economically justified
- Insiders might have less incentive than outsiders to repay a loan

→ Accumulation of bad loans

(LaPorta (2003), connected loans 33 % more likely to default)

The Risk of credit concentration:

- Large exposures to a single borrower or a group of related borrowers
- Particularly during periods of privatization, often banks become centre of industrial empires
 - entrepreneurs divert resources from depositors to themselves and acquire many more firms than otherwise
- Most countries, regulations on the maximum exposure that banks can assume vis-à-vis connected set of borrowers

To sum up :

Lack of ownership transparency makes it more difficult to control insider abuse

→ Can lead to large losses and often is a factor of bank failures

- because connected party loans often on conditions and volumes that are more favorable, than economically justified
- because insider borrowers might be less willing to repay the credit
- because significant risk concentration

b) Asset Stripping :

- Little transparency of ownership, facilitates asset stripping:

“Arrest of assets that belong to a business entity by the manager or owners of the company, ignoring the rights of creditors”

- Took place in the months preceding and following the Russian financial crisis of 1998: When creditors and depositors tried to call in their claims, they were told that debtor institution had no more assets

II) Insolvency of single banks and systemic crises:

- Bank failures viewed to be more damaging than other failures, as the might stabilize the whole system
- Fear that they spread in domino fashion throughout the whole banking system → systemic crisis
- This phenomenon called **contagion**

The case of Contagion:

Different causes for the spreading of banking failures:

- Self-fulfilling panics i.e. in the context of lack of transparency (see “mini-crisis of Russia 2004)
- Close links between banks (for example inter-bank lending)
- Single bank failure could lead to a contraction of common pool liquidity

III) Conclusion:

- Lacking ownership transparency can lead to insider abuse, asset stripping...
- This in turn can lead to insolvency of single banks
- Insolvency of single banks can result via different channels (inter-bank lending, same ownership...) to a banking crisis

→ Transparency of major importance for banking stability