



**Legal Origin, Investor Protection and Bank Credit:
Evidence from Emerging Markets**

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Discussion

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Summary



- ⌘ **Expropriation risk lower, the banks take higher portfolio risk.**
- ⌘ **Using bank level data 1075 banks from 45 emerging- market countries, the authors show that the banks in countries with British legal origin allocate a significantly higher portion of their assets to loans than do banks located in countries with other legal origins.**
- ⌘ **These findings imply that superior legal protection leads to more bank credits and higher economic growth.**

Summary (cont'd)



- ⌘ **Important contribution**
- ⌘ **Similar in spirit to findings in the Law and Finance literature initiated by La Porta et al. (1997 JF, 1998 JPE).**
- ⌘ **Carefully done using several measures and proxies.**
- ⌘ **Liked the paper and recommend it to you.**

Overview



- ⌘ **Big picture view of this paper.**
- ⌘ **Alternate measures.**
- ⌘ **Broader alternate interpretation.**
- ⌘ **Additional directions.**
- ⌘ **Conclusion.**

The Big Picture




- ⌘ **Better laws and enforcement leads to the availability of more external finance.**
- ⌘ **From this perspective, what are the most relevant measures of the effectiveness of the legal system and the efficiency of the enforcement of laws?**
- ⌘ **Legal origins may be a good starting point.**
- ⌘ **Measures of the richness of contracts**

The Big Picture (cont'd)



- ⌘ **Effectiveness of laws governing breach of contracts**
- ⌘ **Insolvency Codes, Bankruptcy systems**
- ⌘ **Is the bankruptcy system, debtor friendly or creditor friendly?**
- ⌘ **US vs. UK**
 - ☒ **Acharya, John and Sundaram (2006).**
- ⌘ **Degree of detail of covenants possible**
 - ☒ **Wei (NYU Working Paper)**
- ⌘ **Strength of creditor rights**

Literature - Empirical



- **La Porta et al. (1997, 1998, 1999, 2002)**
- **Legal Protection is an important determinant**
- **Better legal protection is associated with**
 - **Lower concentration of ownership and control**
 - **More valuable stock markets**
 - **Higher number of listed firms and evaluation**

Literature Empirical (cont'd)



- **Gorton and Schmidt (2000)**
 - **Higher ownership by the large shareholders is associated with higher valuation of assets in Germany**
- **Gompers, Ishi and Merrick (2001)**
 - **US firms in the top decile of a “governance index” (related to takeover defenses and shareholder rights) earned significantly higher abnormal returns over those in the lowest decile.**

Literature Empirical (cont'd)



- **Cremers and Nair (JF, 2005)**
- **Cremers, Nair and Wei (RFS, 2007)**
- **Cremers, Nair and John (2006, NYU Working Paper)**
- **John, Litov and Yeung (JF, 2008 Forthcoming)**
- **John and Litov (NYU Working Paper)**

Literature Empirical (cont'd)



- **Survey: Morck, Wolfenzon and Yeung (JEL, 2005)**

Results (Overview)



- ⌘ **Loans to Total Assets: Increasing in legal origin, decreasing in legal formalism, and decreasing in creditor protection (?)**
- ⌘ **Leverage: Increasing in legal origin, decreasing in legal formalism, and increasing in creditor protection (?)**
- ⌘ **ROA (Profitability): No significant results.**

Alternative Story



- ⌘ **Common Explanation**
- ⌘ **John, Litov and Yeung (JF, forthcoming).**
- ⌘ **John and Litov (NYU, Working Paper).**

- ⌘ **How the investor protection environment affects corporate managers' incentives to take value-enhancing risks.**
- ⌘ **Optimally chosen perk consumption higher, when investor protection is low.**
- ⌘ **Since perks represent a priority claim held by the manager, lower investor protection leads the manager to implement a sub-optimally conservative investment policy with lower NPV.**

Alternate Theory (Cont'd)



- ⌘ **Better Protection => Higher variance, Higher NPV, Lower Leverage**
- ⌘ **Better Creditor Protection => Lower variance, Lower NPV, Higher Leverage**
- ⌘ **Legal formalism => Lower variance, Lower NPV, Higher Leverage**

Alternative Theory-Evidence



- ⌘ We test these predictions.**
- ⌘ Using a large cross-country panel, we find that corporate risk-taking and firm growth rates are positively related to the quality of investor protection.**
- ⌘ In the US we find the same results for US firms as a function of firm-level corporate governance.**

Additional Directions



- ⌘ **Try similar tests for banks in one or two countries.**
- ⌘ **For example, US and Italy. Bank level measure of governance or monitoring or accounting transparency. ASR.**
- ⌘ **Other proxies of bank lending, features of loan contracts, Covenants, Collateral.**

Conclusion



- **Very nice paper. Interesting results on a very important issue.**
- **Effectiveness of legal institutions, how do these affect bank-lending and economic growth.**
- **More broadly: Richness and enforcement of contracts, Effectiveness of governance mechanisms—How do these affect external finance available and hence growth?**