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Inherited or earned? Performance of foreign banks in Central and Eastern Europe

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NON-TECHNICAL SUMMARY

Foreign acquisitions of banks since the 1990s have substantially altered the financial landscape and governance of banks in many transition and developing countries. As of end-2006, foreign banks accounted for more than 39 percent of total banking assets in developing countries. Such a transformation has given rise to a large literature that analyzes the impact of foreign bank ownership and mode of entry on banks' performance, measured by x-efficiency, net interest margin, lending rates, profitability, profit-efficiency, and loan growth. However, there is a striking lack of studies that look at the qualities of banks that were acquired by foreign investors. This is particularly surprising because if foreign banks acquire institutions in developing countries that possess certain characteristics, the standard results of post-acquisition performance are biased.

The hypothesis that selection bias exists - as only banks with certain characteristics were taken over - is supported by evidence, but the direction of this bias often depends on the region. In general, we can plausibly assume that foreign investor would prefer to acquire more profitable and healthier banks with high market power. On the other hand, in many countries the authorities were skeptical towards foreign investors and allowed foreign acquisition of only failing institutions. Very often entry barriers were loosened only in the wake of crises and this was motivated by the need to recapitalize and reestablish a functioning banking system.

In the present paper we propose to use a combination of propensity score matching and difference-in-difference techniques to analyze the impact of bank acquisition by foreign investors controlling for a possible selection bias. We apply this methodology to a dataset comprising 352 banks from 11 Central and Easter European countries (CEECs) between 1993-2005. Our empirical strategy yields a number of interesting results. We show that foreign investors did not acquire banks at random, but chose institutions with large market power. Moreover, the acquired banks were often in poor financial condition. Controlling for this selection bias, we find a positive impact of foreign bank ownership on acquired banks' performance, as well as on their market power. We show that during three years after the takeover, banks have become more profitable due to cost minimization and better risk management. They have additionally gained market share, because they passed their lower cost of funds to borrowers in terms of lower lending rates. Our methodology offers us also a unique possibility to track the dynamics of banks' post-acquisition performance. We show that while the changes in profitability appear one year after the acquisition, market share increases only one period later. In total, the results of our analysis lead us to believe that previous studies failed to pick up these improvements in banks' performance because they assumed that acquisitions were done randomly.

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