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Re-examining the impact of foreign bank participation on interest margins in emerging markets ☆

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ABSTRACT

Over the past two decades, emerging markets have witnessed a considerable increase in foreign bank participation, with the anticipation that foreign entry would lower financial intermediation costs. We re-examine the impact of foreign participation on bank interest margins using data on 11 Central and Eastern European countries (CEECs), where the increase in foreign bank participation was the strongest. Using the modified dealership model of Maudos and Fernandez de Guevara (2004) as a baseline specification, we show that augmenting the model by proxies for direct and indirect impact of foreign bank participation does not produce a significant outcome. We explain our results by the fact that the dealership model fully accounts for the mechanisms through which foreign bank presence is hypothesized to affect interest margins in theoretical models on international banking. We call for re-examination of some of the previous findings showing a significant own effect of foreign bank participation on interest margins in emerging markets within the framework of the dealership model.

1. Introduction

One of the most remarkable developments in international banking during the last two decades has been the sharp increase of foreign bank participation in emerging markets. According to IMF (2000), Central and Eastern European Countries (CEECs) have been the leaders in terms of foreign bank participation among emerging markets, followed by the Latin American countries. Fig. 1 shows that the average market share of foreign banks in 11 CEECs has risen from 14% in 1995 to 80% in 2006. At the moment, foreign banks play a dominant role in banking sectors of all CEECs, except for Slovenia. The

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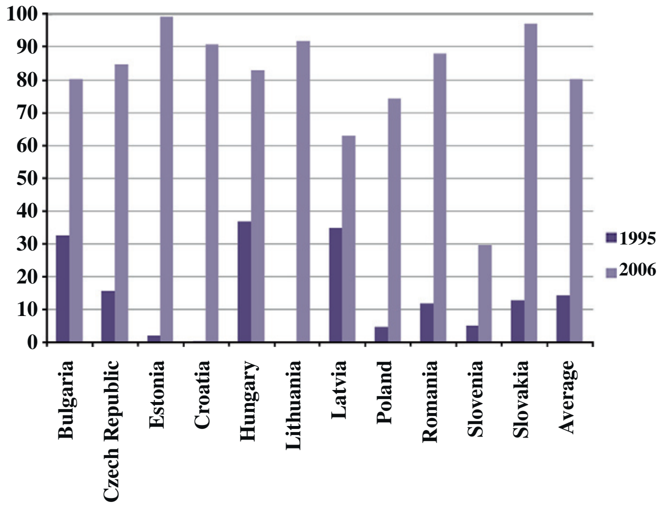

Source: EBRD (2007).

Fig. 1. Market share of foreign banks in CEECs.

observed massive increase of foreign bank participation inevitably raises the question to what extent foreign entry influences banking institutions and their customers in CEECs.

There is a multiplicity of dimensions through which the impact of foreign entry on bank customers could be analyzed. Examples from the literature include stability of domestic banking systems (Gorton and Winton, 1998), banking system concentration and competition (Barajas et al., 2000; Martinez Peria and Mody, 2004; Sengupta, 2007), supply and accessibility of credit (Giannetti and Ongena, 2005; Clarke et al., 2001; De Haas and Naaborg, 2006; De Haas and Van Lelyveld, 2006), banking efficiency (Fries and Taci, 2005; Bonin et al., 2005; Poghosyan and Borovicka, 2007; Havrylchyk and Jurzyk, 2008). This paper addresses one particular aspect of foreign bank participation — its impact on bank net interest margins in host countries.

The importance of the net interest margin as a measure of financial intermediation costs in CEECs arises from the fact that in the absence of developed capital markets firms in CEECs largely depend on bank financing (Berglof and Bolton, 2002). Intuitively, foreign bank entry can have a direct impact on interest margins due to the differences in the level of interest margins set by the foreign-owned and incumbent domestic banks. Foreign bank entry may also have an indirect impact through increased competition and spillover effects. The main problem in evaluating these impacts is the lack of a consistent theoretical framework, which would enable us to disentangle the impact of bank ownership from the impact of other important bank- and country-specific characteristics (for instance, market structure). The existing theoretical literature, widely represented by different forms of the bank dealership model proposed by Ho and Saunders (1981), does not provide a consistent empirical framework to test the impact of foreign bank participation. In the absence of a theoretical framework, the empirical literature relies on various theoretical models on international banking and evaluates the impact of foreign ownership by augmenting the empirical specification of the dealership model by various indicators of foreign bank participation (e.g., number of foreign banks or foreign bank dummy variables) in addition to the theoretically-motivated determinants. The results from these studies are mixed and, among other things, depend on the extent to which all the relevant variables suggested by the dealership model are taken into account.

The aim of this paper is to re-examine the impact of foreign bank participation on interest margins in emerging markets using the CEECs as a laboratory example.[1] Unlike most previous studies, we start our analysis using the contemporary version of the dealership model proposed by Maudos and Fernandez de Guevara (2004), in which the interest margin is modeled as a function of theoretically-motivated

[1] Our sample covers 11 CEECs countries: the new EU member countries and Croatia.