Market discipline in the Central American banking system

Disciplina de mercado en el sistema bancario centroamericano

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Abstract

The hypothesis of market discipline is empirically verified in the Central American banking system. A contrast is carried out on whether the riskier banks (the ones with the worst banking fundamentals) pay higher interest rates and receive smaller amounts in deposits. The generalized method of moments is used for dynamic panel data models (the SYS GMM estimator), as well as a sample of 30 banks from six Central American countries during the 2008–2012 period. Unlike the majority of the previous empirical literature, specifically for developed countries, no evidence of market discipline was found in Central America. The results are robust for several indicators of the banking fundamentals for purposes of internal demand of bank capital, and for other econometric models. These findings indicate weaknesses in the bank policy regarding the disclosure of information.

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Resumen

Se verifica empíricamente la hipótesis de disciplina de mercado en el sistema bancario centroamericano. Se contrasta si los bancos más riesgosos (con peores fundamentales bancarios) pagan tasas de interés más altas y reciben menores cantidades de depósitos. Se utiliza el método general de momentos para modelos dinámicos con datos de panel (el estimador SYS GMM) y una muestra de 30 bancos de 6 países centroamericanos durante

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el periodo 2008-2012. A diferencia de la mayor parte de la literatura empírica previa, particularmente para países desarrollados, en Centroamérica no se encontró evidencia de disciplina de mercado. Los resultados son robustos a varios indicadores de los fundamentales bancarios, al efecto de la demanda interna de capital del banco y a otros métodos econométricos. Estos hallazgos indican debilidades en la política de revelación de información bancaria.

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**Introduction**

After the global financial crisis that started in the United States in 2007–2008, the Basel Committee on Banking Supervision re-evaluated its basic recommendations in 2010, giving rise to the Basel III accord. Criteria for bank stability were reformulated, continuing to be in line with the three pillars indicated in Basel II: minimum capital requirements, bank supervision, and market discipline (Ayadi, 2013; Martínez Castillo, 2007).

The third pillar proposes a bank policy on disclosure of information to decrease moral risks and adverse selection. Said policy, on the one hand, is expensive and cumbersome for banks, and on the other hand, beneficial for society, since it could favor the stability of the banking system (Basel Committee on Banking Supervision, 2006, 2011, 2014). Said information would be utilized by the economic agents, who would make better decisions and would discipline the banks that incur in excessive risks through market, prices and quantity mechanisms, all the while sending market signals to bank supervisors (Tovar-García, 2014).

Evidently, neither the market nor the supervisors were capable of foreseeing and preventing the last banking crises. Nevertheless, the third pillar is still a key factor in the recommendations of Basel, which currently seeks to improve the comparability and consistency of the information to be released (Basel Committee on Banking Supervision, 2014). In this context, this research verifies the presence of market discipline in the Central American banking system. We contrast the hypothesis that states that the riskier banks pay higher interest rates and attract a smaller amount of deposits. The market discipline hypothesis has been positively verified mainly in developed countries (Berger & Turk-Ariss, 2014), and there is also evidence of its presence in formerly socialist countries (Hasan, Jackowicz, Kowalewski, & Kozłowski, 2013), in China (Wu & Bowe, 2012) and in Latin America (Martínez-Pería & Schmukler, 2001). In Central America, the hypothesis has been contrasted only in the case of Costa Rica, with weak evidence in support of it (Mayorga Martínez & Muñoz Salas, 2002). Nonetheless, recent findings suggest that the previous empirical tests are biased, given that they do not consider the internal demand of capital by the banks (Ben-David, Palvia & Spatt, 2013; Tovar-García, 2014).

This research utilizes accounting information (from the overall balance and the income statement) from 2008 to 2012 of 30 banks in Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama. The study contributes to the literature in three ways. First, the hypothesis is reassessed in a new context, where the majority of the Central American countries have deposit insurance and are under the influence of the global financial crisis. Second, the generalized method of moments
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