Chapter 7

Concluding Remarks

7.1 Main Findings

During the last two decades, the financial landscape around the world has undergone dramatic changes following a wave of financial liberalization, globalization, and removal of restrictions on cross-border banking activities. Motivated by these developments in international banking, this thesis analyzes the impact of foreign bank participation on banking systems in host countries. In particular, the thesis addresses the following research questions:

- What motivates banks to expand their activities internationally?
- What is the impact of foreign bank participation on the performance and competition of banking systems in host countries?
- Does the mode of foreign entry matter for the post-entry performance of banks?
- How does increased foreign bank participation affect the costs of financial intermediation?

The key challenge in analyzing these research questions is that the theoretical studies provide contrasting predictions regarding the ultimate impact of foreign bank par-
participation on banking systems in host countries. Empirical investigations are also plagued with a number of difficulties, such as scarcity of adequate data, different macroeconomic and institutional characteristics of host countries, sample-selection issues related to the decision of banks to go abroad. This thesis tries to tackle these empirical challenges by: (i) using bank-level data on FSEs that have experienced a substantial increase of foreign bank participation during the last two decades, (ii) applying innovative empirical methodologies to confront difficulties associated with the empirical assessment of the impact of foreign bank participation.

Chapter 2 analyzes the impact of foreign bank participation on bank performance, focusing on the impact of sample-selection on the decision of foreign banks to go abroad. In particular, the chapter examines whether the positive impact of foreign ownership on the efficiency of banks in FSEs documented in previous studies (Bonin et al., 2005, Fries and Taci, 2005, Yildirim and Philippatos, 2007) may be biased due to the cream-skimming effect. Using a two-step approach (Heckman, 1979), we come up with new evidence suggesting that foreign banks tend to acquire good performing banks when expanding abroad. We further show that after controlling for the sample selection, the positive impact of foreign ownership on bank performance documented in previous studies vanishes. In addition, our results suggest that those FSEs that have attracted more foreign direct investment into their banking sectors are characterized by a lower level of bank efficiency. These findings underscore the importance of exercising care in drawing conclusions regarding the impact of foreign ownership on bank performance in the presence of sample selection problems.

Chapter 3 provides further evidence on the motives driving banks to expand their activities internationally. We build on the previous literature that distinguishes be-

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1 The cream-skimming effect suggests that foreign banks select best performing banks for acquisition, which complicates the empirical analysis of the impact of foreign ownership on bank performance due to the sample selection problem.
tween the efficiency versus market power hypotheses\textsuperscript{2} as motives for foreign expansion (Lanine and Vander Vennet, 2007) and hypothesize that the relative strength of these hypotheses may vary depending on the institutional environment in host countries (EBRD, 2006; Lensink et al., 2008). Using a novel multilevel mixed-effect logistic regression framework, we find support for the market power hypothesis in relatively less advanced FSEs in terms of their economic development and institutional background. This finding is in line with previous evidence of Lanine and Vander Vennet (2007). However, we also show support for the efficiency hypothesis, which holds for relatively more advanced FSEs. Our findings highlight the importance of macroeconomic heterogeneity in FSEs and its relevance for the decision of foreign banks to go abroad.

The discussion of the implications of heterogeneous economic environments in which banks operate for the assessment of their performance is continued in Chapter 4. We start our analysis by noticing that previous studies analyzing performance of banks in FSEs based on the efficiency frontier framework impose a single technology regime in banking. One of the consequences of this restrictive assumption is that in the presence of multiple technology regimes, the obtained inefficiency estimates will be biased (Orea and Kumbhakar, 2004). Moreover, the technology regimes in transition banking are very likely to be affected by notable differences in macroeconomic environments of these countries. Using a novel latent class stochastic frontier methodology, we relax the single-frontier assumption of previous studies and allow for multiple technology regimes in transition banking. Our estimations suggest that transition banking is characterized by three distinct technology regimes. These technology regimes differ not only in terms of relative performance, technological

\textsuperscript{2}The efficiency hypothesis suggests that foreign banks enter host countries with the aim of extracting revenues as a result of upgrading performance of target banks. In contrast, the market power hypothesis suggests that the main motivation for foreign entry is acquisition of large local banks that would allow to exercise market power and extract monopolistic rents.
progress, and returns to scale, but also in terms of the impact of foreign ownership on bank efficiency. More specifically, we find that foreign entry improves efficiency of banks located in FSEs characterized by better economic development prospects and institutional background, while the impact of foreign ownership on the efficiency of banks in less developed FSEs is ambiguous. This result confirms our previous finding on the importance of accounting for the macroeconomic environment in evaluating the impact of foreign bank participation.

Chapter 5 deals with another important aspect of opening the borders for foreign entry: its implications for the competitiveness in the domestic banking industry. The novelty of our approach is that we take into account the impact of foreign entry on bank efficiency when assessing its implications for market competition. In addition, we differentiate between two modes of foreign entry, foreign acquisitions and greenfield establishments, when analyzing the impact of foreign entry on banking competition. This differentiation is important given different motives behind these modes of entry: while greenfield investments are motivated by the follow the client abroad considerations, cross-border acquisitions aim at establishing full scale operations in FSEs. Our results suggest that foreign entry contributes to the competitiveness in the banking industry only for the case of cross-border acquisitions, while the impact of greenfield investments is insignificant. The latter finding can be explained by the special relationships between foreign banks and their customers in FSEs, which adds to the market power of greenfield foreign banks.

In Chapter 6 we investigate the impact of foreign bank participation on the costs of financial intermediation in FSEs, proxied by net interest margins. Theoretical studies on determinants of interest margins (the dealership model) do not consider the role of bank ownership among the determinants (Ho and Saunders, 1981; Maudos and Fernandez de Guevara, 2004), while other theoretical studies outline
various direct and indirect channels through which foreign ownership may matter (Claeys and Hainz, 2007; Dell’Ariccia and Marquez, 2004; Lehner and Schnitzer, 2008). Comparative analysis of both types of theoretical studies reveals that the main channels through which foreign ownership may matter for the cost of financing are taken into account by the \textit{dealership} model. Our empirical analysis supports this hypothesis and suggests that after taking into account the theoretically motivated determinants of interest margins discussed in the \textit{dealership} model, the own impact of foreign ownership is insignificant. This finding is in contrast to previous studies, which did not take into account all theoretically motivated determinants and found significant impact of foreign ownership dummies, interpreting those as own effects of foreign ownership on the cost of financing.

### 7.2 Policy Implications

The analysis conducted in this thesis confirms the general expectations of policymakers that increased foreign bank participation will have a positive impact on FSEs, but with some caveats. First of all, the analysis shows that the impact of foreign bank entry is not uniform across FSEs. On average, more developed FSEs with a better record for policy reforms seem to have gained more from foreign bank participation than the others. Related to this, the causal relationship between foreign bank participation and performance may have gone also in the opposite direction, namely improvement of overall economic performance and positive prospects of EU membership have attracted foreign banks to the advanced FSEs. Next, the mode of foreign entry needs to be taken into account by the policymakers when formulating policies encouraging the foreign bank entry. Different motivations behind these modes result in different post-entry performance of foreign banks and should be weighed by policymakers with care. Finally, further efforts need to be undertaken to improve
the competitive stance of transition banking systems. Although foreign entry im-
proves competition on the margin, it should not be treated as panacea of solving all 
problems in the domestic banking markets. A substantial degree of market power is 
still present in most FSEs’ banking sectors.