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# Bank valuation in new EU member countries

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ABSTRACT

This paper studies the role of institutional reforms in affecting bank valuation in new European Union (EU) member countries. It takes advantage of the dynamic nature of institutional reforms in transition economies and explores the causal effects of those reforms on banks' Tobin's Q over the period of 1997–2008. Using a difference-in-difference approach, the paper shows that Tobin's Q increases substantially after these countries reform their legal institutions and liberalize banking. However, it decreases after stock market reforms. After further examination of the interactive relationships between different reforms and bank valuation, it is observed that when the banking reform is well implemented, legal reform can have a stronger impact on banks' Tobin's Q. On the other hand, banking reform and security market reform has a substitutive relationship. The analysis also suggests that foreign ownership, market power, and asset diversification significantly affect Tobin's Q. These results are robust even after simultaneously controlling for equity risk.

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## 1. Introduction

The development of a sound banking system is vital to a country's economic stability and long-term growth (Allen and Gale, 2000; Levine, 2005). This is especially true for transition economies, where capital markets are underdeveloped and the financial needs of enterprises are mostly met through banking sectors. Most importantly, the recent 20 years have witnessed substantial institutional reforms in both the financial and the enterprise sector. How these reforms in transition economies affect bank market development has attracted considerable interest from academia as well as policymakers.[1]

Prior studies examining the relationships between institutional reforms and bank performance have traditionally used accounting and efficiency measures (e.g. Bonin et al., 2005a,b; Brissimis et al., 2008; Poghosyan and Poghosyan, 2010; Fang et al., 2011b). In this paper, we pay special attention to the valuation of publicly traded banks as measured by the market-to-book value of equity (Furlong and Kwan, 2005; Caprio et al., 2007). In particular, we examine how substantial changes in institutional environments are transmitted to the banking sector and affect bank valuation and, secondly, how different reforms interact with each other to exercise an impact on bank valuation. In addition, we analyze bank-specific factors that are related to bank valuation, including market power, foreign ownership, and asset diversification.

The examination of bank valuation is motivated by three considerations. First, the structural changes of banking regulation, financial market structure, and competition environment in transition economies are likely to alter the valuation of banks in a significant way. Second, with the development of security markets, more transition banks are traded publicly in the local stock market. This makes bank valuation a timely and important issue to examine. Especially, Tobin's Q could capture the further growth opportunities of a bank, which is crucial for shareholders (Laeven and Levine, 2009). Third, under the Basel Capital Accord, greater supervisory efforts have been focused on risk management and enhancing the capital ratio. Having a sound charter value has been documented as a key contribution to reduce risk-taking incentives of shareholders, since they would risk all their value in the event of a downside (Keeley, 1990; Hellmann et al., 2000; Repullo, 2004).

In examining the role of institutional reforms, we look at banking reform, security market reform, and legal reform. Banking reform refers to a series of deregulation activities that took place in the banking sectors of major transition economies. In order to establish efficient market-oriented banking sectors, governments liberalized interest rates and decentralized central banks' commercial banking activities to state banks. To foster competition, they also privatized a large number of domestic banks and allowed foreign banks to enter the market. Legal reform refers to government efforts in reforming legislation and financial laws to create an investor-friendly, transparent and predictable legal environment. In particular, collateral and bankruptcy laws were revised following the standard of Western model laws (Dahan, 2000). It has been documented that the overall quality of the legal environment of transition countries has substantially improved over the past decade (Pistor, 2000).

We apply a difference-in-difference framework to explore the exogenous changes of banking reform, legal reform, and security market reform over time across countries.[2] Specifically, we obtain yearly measures of legal reforms, banking liberalization, and security market reform for these transition countries from 1997 to 2008. For each year, countries that experienced reforms belong to the treatment group and countries with no changes belong to the control group. Given that the reforms in transition countries took place at different time periods in different countries, we apply the DID approach in a multiple groups and multiple time periods framework (Bertrand and Mullainathan,

[1] Since the break-up of the former Soviet Union and the fall of the Berlin Wall, a large number of countries in Central and Eastern Europe and the Baltic regions as well as the Euro-Asian Caucasus started their transition toward more democratic and market-oriented economies. Researchers analyzing these transition countries typically divide them into two groups. One consists of the Former Soviet Union (FSU) countries and the other of the non-FSU countries. The countries considered in this paper are Central and Eastern European countries from the non-FSU group. It should be noted here that in recent years some researchers have also included China, Mongolia, and Vietnam in defining economies or countries in transition.

[2] Arguably, institutional reforms can be seen as exogenous because they are motivated and supervised by external organizations such as the European Union (EU), the European Bank for Reconstruction and Development (EBRD), and USAID (Giannetti and Ongena, 2009; Haselmann et al., 2010).

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