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Do privatized banks in middle- and low-income countries perform better than rival banks? An intra-industry analysis of bank privatization

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Abstract

This paper presents a comprehensive analysis of the pre- and post-privatization operating performance and stock market performance of privatized banks and their rivals in middle- and low-income countries. First, we find that privatization announcements elicit negative abnormal returns for rival banks. The effects are more pronounced for subsequent tranche sales where the proportion of government ownership in the privatized bank is reduced. Second, we observe that the privatized banks underperformed the benchmark index in the long run. Investors who bought shares of the privatized banks on the first day of trading and held them for 5 years (instead of investing in the market index) lost 24% of their wealth. The underperformance is consistent with the negative long run returns that have been documented for initial public offerings. Third, we document marginal improvements in the post-privatization operating performance of the privatized banks. Though the privatized banks in middle- and low-income countries are better capitalized than rival banks, they carry higher problem loans and are overstaffed relative to other private banks in the post-privatization period. Since most of the sample firms are partially privatized, we submit that perhaps the continued government

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ownership of the privatized banks might have hindered managers' ability to restructure the firms.

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1. Introduction

Prior studies have found that privatization of state-owned enterprises (SOEs) improves the firms' performance. For example, Megginson et al. (1994) and Boubakri and Cosset (1998) document strong performance improvements for their sample of privatized firms in developed and developing countries respectively. Unlike privatization of non-financial firms where a reasonably large number of research work exists, empirical work on bank privatization is only beginning to emerge. Also, unanswered in previous research is whether there is a significant information transfer effect associated with privatization.

An information transfer effect is the change in the value of a firm that can be attributed to firm-specific announcements made by other firms. We argue that privatization can have positive information effects or competitive effects on rival firms. Under the competitive effect hypothesis, rival firms would react negatively to privatization announcements if investors believe that there is now a more efficient, aggressive and rejuvenated competitor in the industry whose operations can lead to falls in product prices and, hence, erode the profitability of the rival firms. On the other hand, under the information effect hypothesis, privatization announcements could signal positive information about the industry rivals if for example privatization is accompanied or preceded by deregulation. In this paper we examine rival banks' reaction to privatization announcements and then analyze the pre- and post-privatization operating performance and post-privatization stock market performance of privatized banks relative to that of rival banks in middle- and low-income countries.

We study bank privatization in middle- and low-income countries for a number of reasons. First, like most state-owned firms, government-owned banks are characterized by inefficiencies and profitability problems which emanate, inter alia, from the maintenance of low quality loan portfolios that resulted from the granting of loans to poorly performing state enterprises and political supporters (La Porta et al., 2002; Megginson, 2005). However, because of the pivotal role state banks play in the development of efficient financial systems in these countries, their privatization usually generates serious opposition from interest groups and the community at large. Second, Perotti and Guney (1993) argue that banks in emerging economies have strong but perverse incentive to continue to fund former debtors (i.e., state enterprises) that are less efficient and more risky than private firms because doing so enables them to gain the potential of repayment of previous debt granted to them when the bank was a state bank. Given this incentive to continue to fund risky clients and