

Bad luck or bad management? Emerging banking market experience

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Abstract

A large number of bank failures occurred in transition countries during the 1990s and at the beginning of the 2000s. These were related to increases in non-performing loans and deteriorated cost efficiency of banks. This paper addresses the question of the causality between non-performing loans and cost efficiency in order to examine whether either of these factors is the deep determinant of bank failures. We extend the Granger-causality model developed by [Berger, A., DeYoung, R., 1997. Problem loans and cost efficiency in commercial banks. *J. Banking Finance* 21, 849–870] by applying GMM dynamic panel estimators on a panel of Czech banks between 1994 and 2005. Our findings support the bad management hypothesis, according to which deteriorations in cost efficiency precede increases in non-performing loans. Banking supervisors should consequently focus on enhanced cost efficiency of banks in order to reduce the likelihood of bank failures in transition countries.

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1. Introduction

A large number of bank failures occurred in transition countries during the 1990s and, to a lesser degree, at the beginning of the current decade. In the Czech banking sector for instance,

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out of the 48 banks operating in 1994 and another 6 licensed later on, 21 banks had failed by 2003. It is therefore of utmost interest to know which factors predict bank failures. The empirical literature identifies two main factors predicting bank failures. The first one is the volume of non-performing loans in the loan portfolio. A large proportion of non-performing loans has been widely observed in the loan portfolio of failing banks. The second one is a low level of cost efficiency. The role of enhanced banking efficiency in reducing bank failures has been pointed out in studies in developed countries (e.g. Barr et al., 1994) and transition countries (Podpiera and Podpiera, 2005)¹. The underlying argument is that bad management increases the likelihood of bank failures.

However, the big question is whether either of these factors is the deep determinant of bank failures. If one factor causes the other one, it may therefore be considered as the key determinant of bank failures—both through its direct impact and through its indirect influence via the other factor. As a consequence, the sense of causality between non-performing loans and cost efficiency is of utmost interest for the analysis of the causes of bank failures.

Following the empirical observation of a negative relationship between non-performing loans and cost efficiency, two assumptions have been proposed by Berger and DeYoung (1997). These differ on the direction of the causality. On the one hand, the bad luck hypothesis states that non-performing loans influence cost efficiency. The underlying argument is that external events such as economic slowdowns affect non-performing loans, resulting in banks incurring extra costs to deal with these loans, which, in turn, weakens cost efficiency. On the other hand, the bad management hypothesis predicts that cost efficiency exerts an impact on non-performing loans, as bad managers do not monitor loan portfolios efficiently.

The identification of the key determinant of bank failures is a fundamental issue for the authorities in charge of supervising the banking industry, as the implications for economic policy strongly differ depending on its origin. Specifically, if non-performing loans influence cost efficiency, banking supervisors should limit banks' risk exposures by restricting loan concentration and favoring diversification. In contrast, an influence of cost efficiency on non-performing loans would suggest that the latter are caused internally. Therefore, banking regulators and supervisors should focus on improving cost efficiency through better education of bank managers and through increased foreign ownership, as this latter element has been shown to favor cost efficiency, primarily through the transfer of know-how (Weill, 2003; Bonin et al., 2005).

A couple of papers have investigated this issue for developed countries. Berger and DeYoung (1997) provide some support for both hypotheses on a sample of US banks, as they observe that the relationship runs in both directions. Williams (2004) concludes in favor of the bad management hypothesis on a sample of European savings banks.

However, this question is of greater importance in transition countries, owing to the importance of the bank failure phenomenon in these countries. In spite of this aspect, no study has yet been published providing a thorough investigation of the causality between non-performing loans and cost efficiency in transition countries. To our knowledge, the only paper on this topic is Rossi et al. (2005), which concludes in favor of the bad luck hypothesis on a sample of banks from nine transition countries.

Our aim in this paper is to provide empirical evidence on the source of bank failures in transition countries by investigating the causality between cost efficiency and non-performing loans for the

¹ This study provides evidence that greater cost efficiency of banks reduces the likelihood of bank failures and therefore contributes to financial stability in the Czech Republic.

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