



Shareholder value efficiency in European banking

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Abstract

This paper advances the studies of [Hughes, J.P., Lang W.W., Mester L.J., Moon C.G., Pagano M.S., 2003. Do bankers sacrifice value to build empires? Managerial incentives, industry consolidation, and financial performance. *Journal of Banking and Finance* 27, 417–447] by developing a new measure of bank performance which we refer to as “shareholder value efficiency” – a bank producing the maximum possible Economic Value Added (EVA), given particular inputs and outputs, is defined as “shareholder value efficient”. This new efficiency measure is estimated using the stochastic frontier method focussing on the French, German, Italian and UK banking systems over the period 1997–2002 and includes both listed and non-listed banks. We find that European banks are, on average, 36% shareholder value inefficient. Shareholder value efficiency is found to be the most important factor explaining value creation in European banking, whereas cost and profit efficiency only have a marginal influence.

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1. Introduction

A substantial body of literature has emerged on bank efficiency and shareholder value issues, but these have mainly developed separately. Studies dealing with bank efficiency

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focus on methodological issues (e.g. Berger, 1993; Altunbas and Chakravarty, 2001), compare estimates from different approaches (e.g. Berger and Mester, 1997; Bauer et al., 1997), estimate bank efficiency focussing on countries and/or financial sectors that have not been analysed in previous studies (e.g. Sathye, 2001; Green and Segal, 2004; Beccalli, 2004) and assess the sources of bank inefficiency and the role of environmental factors (e.g. Dietsch and Lozano-Vives, 2000; Berger and De Young, 2001; Chaffai et al., 2001). The shareholder value literature typically focuses on developing and comparing new performance measures (e.g. O'Hanlon and Peasnell, 1998; Garvey and Milbourn, 2000), evaluates how traditional company performance measures, usually accounting indicators, explains variation in shareholder value (e.g. Barth and Beaver, 2001; Holthausen and Watts, 2001), and evaluates other relationships between market and accounting values (e.g. Ohlson, 1995; Felthman and Ohlson, 1995; Dechow et al., 1999; Lo and Lys, 2000; Liu and Ohlson, 2000; Biddle et al., 2001; Ota, 2002).

Over the last decade or so, only a few studies (e.g. Beccalli et al., 2006; Eisenbeis et al., 1999; Chu and Lim, 1998) have attempted to bring together these two branches of literature by empirically analysing the relationship between bank efficiency and shareholder value creation. These studies have usually focussed on publicly listed bank by assessing the explanatory power of various efficiency and productivity measures on stock market returns – typically they usually provide evidence of a positive relationship between efficiency/productivity and stock market returns. Beccalli et al., 2006; for example, estimates cost efficiency for a sample of European listed banks and find that changes in the prices of bank shares reflect percentage changes in cost efficiency – particularly those derived from the data envelopment analysis (DEA) efficiency estimates. Eisenbeis et al. (1999) investigate the ability of cost efficiency (estimated using DEA and SFA) to explain risk-taking behaviour, managerial competence and bank stock returns. They find a negative relationship between cost inefficiency and stock returns and conclude that the stochastic frontier cost efficiency estimates provide more information relating to stock returns compared with the DEA efficiency measures. Chu and Lim (1998) analyse a panel of six Singapore listed banks and find that changes in bank stock prices are more closely related to changes in profit rather than cost efficiency.

While it is recognised that “profit maximisation is superior to cost minimisation for the study of firm performance because it more completely describes the economic goals of firms and their owners, who take revenues into account as well as costs” (Berger et al., 1999, p. 12), the relationships between these efficiency measures and shareholder value creation is by no means certain. A company creates value for shareholders over a given time period when the return on invested capital is greater than its opportunity cost, or than the rate that investors could earn by investing in other securities with the same risk. As profit efficiency measures typically do not explicitly take account of risk or the opportunity cost of capital they may not be the most relevant performance indicator reflecting bank strategy and behaviour.

In order to address these limitations Hughes et al. (2003, 2004) propose a different approach to analyse efficiency and stock values relationships by developing the concept of market-value shortfall (i.e. the shortfall of a bank's market value from its highest potential market value) and the ‘shortfall ratio’ (i.e. the shortfall of a bank's market value from its highest potential market value as a proportion of the bank's book-value investment in its assets, net of goodwill). Hughes et al. (2003, 2004) estimated this new efficiency measure using stochastic frontier techniques to fit an upper envelope of market value (market value frontier) and the difference between the envelop value and the achieved market value is defined as market value efficiency. Using a sample of 169 US publicly listed bank holding

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