



The determinants of shareholder value in European banking

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ABSTRACT

This paper examines the determinants of shareholder value creation for a large sample of European banks between 1998 and 2005. As the recent turmoil in global banking systems has illustrated, bank performance can have a substantial influence on efficient capital allocation, company growth and economic development. We use a dynamic panel data model where the bank's shareholder value is a linear function of various bank-specific, industry-specific and macroeconomic variables. We show that shareholder value has a positive relationship with cost efficiency changes, while economic profits are linked to revenue efficiency changes. Credit losses, market and liquidity risk and leverage are also found to substantially influence bank performance. These results are robust to a variety of different model specifications.

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1. Introduction

European banking has experienced substantial changes over the last two decades as various forces such as structural deregulation, prudential reregulation, technological advances and globalisation have changed the competitive landscape (Goddard et al., 2007). As a consequence, it is not surprising that there is a well established and growing literature that focuses on various factors that influence the performance of banks. As the turmoil in global banking systems since mid-2007 has illustrated, bank performance can have a substantial influence on efficient capital allocation, company growth and economic development in general. Consequently, it is crucial to assess how banks make profits and create value for their owners.

Recent studies (Berger et al., 2004; Berger and Mester, 2003; Salas and Saurina, 2003; Athanasoglou et al., 2008; Brissimis et al., 2008; Lepetit et al., 2008) tend to consider a range of factors (bank-specific, industry-specific and macroeconomic) that are believed to have an impact on bank profitability. Focussing on studies dealing with European banking, Brissimis et al. (2008), examine

the relationship between bank performance (measured by three measures: productive efficiency, total factor productivity growth and net interest margin) with banking sector reforms (measured using the EBRD index of banking sector reform), bank competition variables and bank risk-taking variables (focussing on credit, liquidity and capital risks) between 1994 and 2005. Overall they find that (a) banking sector reform and competition have a positive impact on productive efficiency; (b) capital and credit risk have a negative relationship with the majority of bank performance measures; and (c) liquid assets reduce bank efficiency and productivity. Similarly, Athanasoglou et al. (2008) examine the effect of bank-specific (i.e. capital, productivity growth, efficiency, credit risk, size), industry-specific (i.e. ownership and concentration) and macroeconomic (i.e. inflation and cyclical output) determinants on bank profitability using a sample of Greek banks between 1985 and 2001. The authors find that all bank-specific determinants (with the exception of size) influence bank profits. Lepetit et al. (2008) analyse the relationship between bank risk and product diversification using a sample of European banks between 1996 and 2002. According to their findings, banks with higher non-interest income display higher risk than banks which mainly supply loans. Namely, the positive link between risk and non-interest income is most apparent for small banks: this is essentially related to commission and fee activities, while a higher share of trading activities is not associated with higher risk. Other studies consider different source of profits focussing on other bank features. For

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example, Cummins et al. (2006) and Gillet et al., 2010 investigate the relationship between operational risk and bank stock price reactions. Other studies focus on bank financial structure (e.g. Berger and Bonaccorsi di Patti, 2006; Margaritis and Psillaki, forthcoming) finding that higher leverage (or a lower equity capital ratio) is generally associated with higher efficiency, all else equal. Other studies (e.g. Kwan and Eisenbeis, 1997; Demirgüç-Kunt and Huizinga, 2004) recognise that loan and deposit growth rates are a useful indicator of bank profitability and soundness.

While there is a well established and growing literature that focuses on various factors that influence the performance of banks, few studies use shareholder value creation metrics as their performance indicator. This is surprising given that creating value for shareholders has been the main strategic objective of banks over the last decade or so. Unexpectedly, a small number of studies have sought to link measures of bank productive efficiency to shareholder value and, generally find a positive relationship. Fiordelisi (2007) develops a new measure of bank performance (referred to as “shareholder value efficiency”) where a bank producing the maximum possible Economic Value Added (EVA), given particular inputs and outputs, is defined as “shareholder value efficient”, while Beccalli et al. (2006) test the relationship between stock returns (dependent variable) and various efficiency measures, generally finding a positive link between return and improvements in efficiency. The main limitation of these studies is that these studies typically focus on the relationship between shareholder value and just one type of bank-specific determinant (i.e. bank efficiency), but do not say much about other factors that may influence shareholder returns (such as bank’s risk-taking, cost of capital, firm growth, etc.). In addition, these studies do not take into account the cost of capital so using simple stock returns as a measure of shareholder value may be over-stated.

Overall, the extant empirical literature on the determinants of shareholder value creation in banking appears somewhat limited (especially compared with those dealing with the determinants of bank profitability). This paper aims to extend the established literature by: (1) jointly analysing a broad range of factors impacting on shareholder value creation in European banking; (2) empirically testing the causality of these factors in the value creation process; (3) including both listed and non-listed banks in our analysis; (4) taking into account trade-offs between various value determinants. As such, this paper aims to provide a comprehensive study of the determinants of shareholder value creation in European banking.

2. The value creation process in banking

The concept of shareholder value is one of the oldest nostrums in business (Marshall, 1890): a company creates value for its shareholders when the return on invested capital is greater than its opportunity cost. As a consequence, shareholder value creation over the period $t - 1, t$ ($\psi_{t-1,t}$) can be obtained by investigating the Abnormal Returns (AR) generated by capital invested by shareholders. Although the calculation is straightforward, such a procedure can only be adopted for publicly traded companies and this creates limitations for evaluating value creation in European banking as only a relatively small number of quoted banks exist. In this paper, we aim to analyse shareholder value creation focussing on listed and non-listed banks to have a broader assessment of value creation in the European banking industry. A common measure of shareholder value creation is Economic Value Added (EVA), defined as the Euro surplus value created by a firm on its existing investments. The EVA ($\psi_{t-1,t}$) is calculated as the difference between “economic measure” of the bank net operating profits (π) and a capital charge over the same period, i.e. the product of invested

capital at time $t - 1$ (K) and the estimated cost of capital (k), i.e. $\psi_{t-1,t} = \pi_{t-1,t} - kK_{t-1}$.

At first sight, the shareholder value creation process seems to be straightforward: a bank needs to put actions in place to increase the net operating profits and/or reduce the opportunity cost of capital and/or reduce the capital invested. Net operating profits improvements depend on bank income and cost structures in particular: net interest margins (i.e. interest revenues minus interest costs and expected credit losses), fee income (i.e. fee revenues less fee costs), security investment returns (i.e. capital gains plus dividends less capital losses from bank stock investments) and operating costs. These revenues and costs depend on bank-specific factors (namely, cost and profit efficiency, bank risk-taking, financial structure, deposit and loan growth rates, etc.) as well as industry-level factors (e.g. industry concentration, bank market power, etc.) and country-level factors (e.g. country richness and demographic features). Similarly, the opportunity cost of capital (i.e. the rate of return required by shareholders for investment with a similar risk level) depends on the riskiness of future cash flows. The opportunity cost of capital may be reduced by reducing risk exposure or improving risk management. Finally, capital invested can be reduced by increasing financial leverage.

The value created for shareholders is the final result of a process including all bank’s stakeholders and it can be safely assessed only considering two issues: (1) the trade-off between various bank actions; (2) how quick actions pay off. Regarding the first issue, there are few “pure value creator” actions that banks can take to increase value, while there is usually a trade-off among value-determinants. Most actions have both positive and negative effects on shareholder value creation and it is the net effect that will determine whether any action is value enhancing. A first example is on bank’s efficiency: banks usually act to improve their operating efficiency with the ultimate goal of creating value; however, this action may have different consequences which may impact negatively on shareholder value. For example, ‘aggressive’ efficiency programmes may result in reduced customer satisfaction, have an adverse impact on workforce motivation or increase risk, all of which may adversely affect value creation. Moreover, it is also necessary to consider redundancies costs (e.g. economic incentives grant to staff for leaving the banks) that are likely to have a negative impact on shareholder value. A second example: a bank may try to increase its EVA by reducing capital invested and, consequently, increasing its financial leverage. However, this reduces equity capital availability by increasing bank business risk: this may result in a higher cost of capital so it is not certain that increasing leverage will increase shareholder value. Another example: a bank with skills in managing its market risk exposure may decide to increase the proportion of assets invested in securities in order to increase its net operating profits. However, this will reduce the proportion of interest-bearing assets or liquidity reserves, which may lead to an increase in the opportunity cost of capital. Again, a bank may also attempt to increase net operating profits by growing in size (e.g. perhaps, market power enables the bank to set more favourable interest rate spreads). However, this may decrease cost efficiency (e.g. larger banks, because of their complexity may be more difficult to manage efficiently) and increase operational risk (e.g. larger banks may be more exposed to staff frauds or IT malfunctioning): these factors will influence other shareholder value determinants making it uncertain as to the overall effect on shareholder value creation.

Regarding the second issue (i.e. how quick actions pay off), some actions would be expected to generate an immediate increase in value (e.g. capital disinvestments), while other actions need time to have an impact on shareholder value (e.g. increasing size to build market power or improvements in cost efficiency may take time before these feed through into increases in net operating

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